



# **AUDIT INSPECTION UNIT**

## **2008/9 AUDIT QUALITY INSPECTIONS**

### **AN OVERVIEW**

**7 DECEMBER 2009**

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

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# 1 Introduction and overview of findings

## 1.1 Introduction

This report provides an overview of the activities and findings of the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), a part of the Financial Reporting Council (“the FRC”), for the year ended 31 March 2009.

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

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

Baker Tilly UK Audit LLP

BDO LLP

Deloitte LLP

Ernst & Young LLP

Grant Thornton UK LLP

Horwath Clark Whitehill LLP

KPMG LLP and KPMG Audit Plc

PKF (UK) LLP

PricewaterhouseCoopers LLP

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

## 1.2 Structure of this report

This report is set out under the following sections:

- Section 2 provides an overview of the inspection process and other activities undertaken by the AIU in 2008/9,
- Section 3 provides an overview of key findings arising from the AIU’s inspections at major firms in 2008/9,
- Section 4 summarises the findings from the AIU’s inspections at other firms in 2008/9,
- Section 5 discusses a number of challenges currently facing auditors,
- Appendix A provides a list of the other firms, and
- Appendix B details the scope of independent inspections for 2008/9 as determined by the Oversight Board.

## 1.3 Overview of findings

Set out below is an overview of the findings from the AIU's inspections at both major and other firms.

### 1.3.1 *Major firms*

The AIU considers the overall quality of major public company audit work to be fundamentally sound.

For each major firm the AIU has recommended to the relevant Audit Registration Committee that the firm's registration to conduct audit work be continued.

The AIU was generally satisfied with the basis on which significant audit judgments were made on the individual audits reviewed at the firms. It considered that audit procedures had generally been performed to a good or acceptable standard. However, the AIU identified certain areas at each major firm where improvements were in its view needed in order to enhance audit quality.

The AIU reviewed 70 audits at major firms excluding follow-up reviews (2007/8: 72 audits excluding follow-up reviews). Eight of these were considered by the AIU to require significant improvement in certain areas (2007/8: 11 audits). Of these audits, seven related to listed or AIM entities including four FTSE 350 entities.

The AIU also undertook nine follow-up reviews (2007/8: eight follow-up reviews). As in the prior year, the AIU considered that all or most matters identified previously had been satisfactorily addressed in the subsequent audits.

### 1.3.2 *Other firms*

The AIU considered that the issues identified from its inspection work at other firms were not dissimilar in nature to those identified at the major firms. However, the extent of issues identified and the proportion of audits requiring significant improvement was greater than at the major firms. This may partly reflect the fact that this was the first inspection visit by the AIU to six of the ten firms inspected in 2008/9.

The AIU reviewed 11 individual audits excluding follow-up reviews (2007/8: 10 reviews). In the AIU's view significant improvements were required in certain areas on five of these audits (2007/8: seven audits), four of which related to AIM entities.

In addition, the AIU undertook two follow-up reviews (2007/8: no follow-up reviews). The AIU considered that most issues had been satisfactorily addressed on one of these audits.

However, many issues had still to be addressed on the other audit and a further follow-up review will be undertaken in 2009/10.

Detailed findings in relation to the AIU's inspections at major and other firms are set out in sections 3 and 4 of this report respectively.

## **2 Scope and background**

### **2.1 Introduction**

This section provides an overview of the AIU's inspection and reporting processes, the coverage of its inspections and details of other activities undertaken in 2008/9.

### **2.2 AIU inspection process**

The AIU's inspections of the major audit firms, on which it reports publicly, comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board. The scope of inspections for 2008/9 is set out in Appendix B.

The AIU reviews the major firms' policies and procedures in the following areas:

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

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

The AIU's inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the Auditing, Ethical and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board (APB)<sup>1</sup> and other relevant requirements

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<sup>1</sup> International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

under the Audit Regulations<sup>2</sup>. The AIU also assesses judgments exercised by firms in applying the principles underlying the APB's Standards.

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

The AIU provides the Audit Registration Committees of the professional accountancy bodies in the UK which register firms to conduct audit work with a report on each major firm containing findings relating to safeguarding or improving audit quality, together with an overall recommendation on whether the firm's audit registration should be continued.

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

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

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

The AIU's inspections of other firms are limited to a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection as set out in Appendix B. The AIU reports the findings from its reviews of individual audits at other firms to the relevant Audit Registration Committee.

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<sup>2</sup> The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

The monitoring units of the professional accountancy bodies in the UK review the other firms' policies and procedures supporting audit quality. Section 2.8 outlines certain related oversight activities undertaken by the AIU on behalf of the Oversight Board.

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

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

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

The AIU has, in accordance with its confidentiality operating procedures, shared certain information obtained from its 2008/9 inspections with the FRRP and the AADB where relevant to their respective responsibilities.

### **2.3 Coverage of inspections**

During 2008/9, the AIU undertook full scope inspections, comprising a review of policies and procedures supporting audit quality and individual audits within its scope, at all major firms listed in section 1.1 with the exception of PKF (UK) LLP. That firm formed part of the AIU's inspection programme in 2007/8 and will also be subject to inspection in 2009/10.

The "Big Four" firms<sup>3</sup> will continue to be inspected on an annual basis. These firms audit approximately 80% of the entities within the AIU's scope, including around 95% of FTSE 350 entities within its scope. From 2009/10 the AIU will be altering the frequency and

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<sup>3</sup> The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

timing of its inspections at the other major firms in line with its risk-based approach. This will result in inspections at these firms being undertaken over an extended period of approximately two years.

In 2008/9 the AIU also carried out inspections at ten other firms. For these firms, the AIU's inspections comprised reviews of one or more audits of listed or other major public interest entities.

Staff from the US Public Company Accounting Oversight Board ("the PCAOB") participated in certain aspects of the AIU's 2008/09 inspection of Grant Thornton UK LLP, by agreement with the firm. The PCAOB undertakes inspections of firms that audit companies whose securities are traded on US securities markets. The AIU believes that effective co-operation with overseas 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.

At the request of the Audit Commission, the AIU also undertook an inspection on a contractual basis covering its policies and procedures supporting audit quality and selected individual audits. Entities audited by the Audit Commission are outside the scope of audit regulation and the findings of this inspection are therefore not covered in this report.

#### 2.4 Analysis of audits reviewed by the AIU

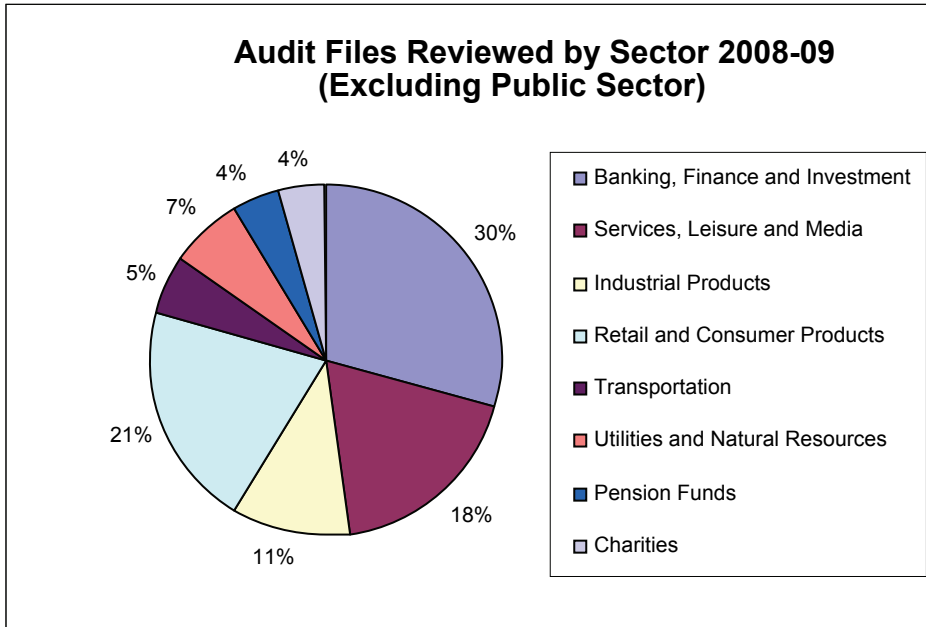
In the year to 31 March 2009, including reviews performed under contractual arrangements for the Audit Commission which are not subject to AIU public reporting, the AIU completed the review of 99 engagements undertaken by audit firms, compared with 95 in 2007/8. An analysis of audit engagements by type of firm is set out in the following table.

Firm type		File reviews 2008/9	File reviews 2007/8
Major firms	Big four firms	54	60
	Other major firms	25	20
Other firms		13	10
<b>Total excluding public sector</b>		<b>92</b>	<b>90</b>
Public sector	Audit Commission	7	5
<b>Overall total</b>		<b>99</b>	<b>95</b>

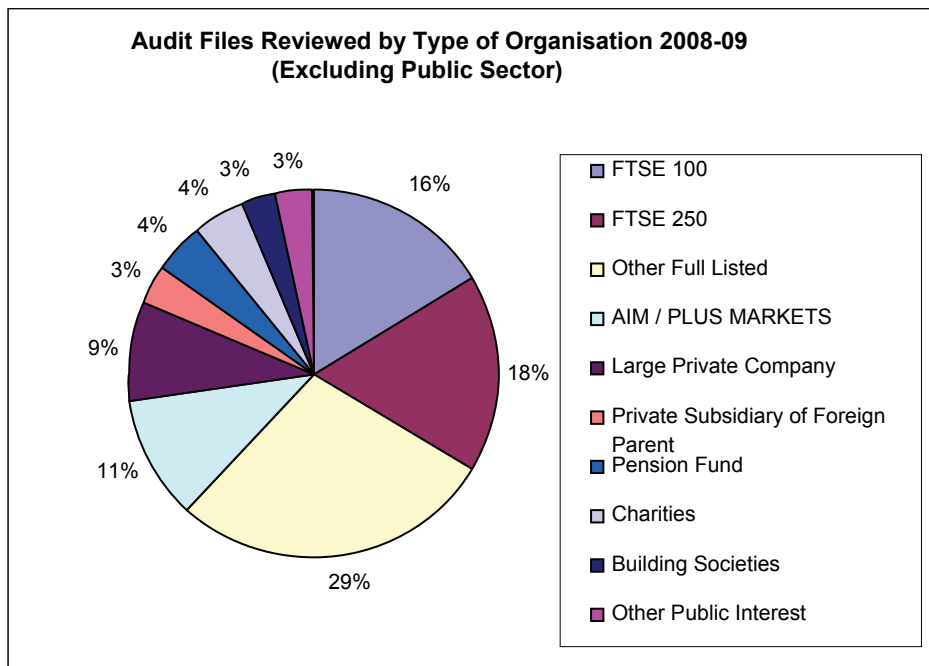
The above totals include 11 follow-up reviews (2007/8: eight follow-up reviews) undertaken to assess the extent to which the AIU's prior year findings had been addressed in the following year's audit.

The audits reviewed in 2008/9 had financial years ending between March 2007 and December 2008, the majority of which were either 31 December 2007 or 31 March 2008 year ends.

An analysis by sector of the audits reviewed by the AIU in 2008/9 is set out below:



An analysis by type of organisation of the audits reviewed by the AIU in 2008/9 is set out below:



In the five years since the AIU commenced its inspection activities in 2004, it has reviewed in excess of 400 audits, including the audits of 83 FTSE 100 and 97 FTSE 250 entities.

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

As part of its 2009/10 inspection programme, the AIU has further refined its file selection and review processes in response to the challenges presented by the economic downturn. It is undertaking a number of reviews primarily focusing on the audit of going concern, the potential impairment of goodwill and other intangibles and fair value accounting estimates and disclosures. In addition, a greater proportion of the AIU's reviews in 2009/10 will relate to audits undertaken by the Big Four firms. The overall number of audits reviewed in 2009/10 is expected to be slightly higher than that achieved in 2008/9.

## **2.5 External reporting on inspections**

The AIU has published, in two batches on 5 November and 7 December 2009, individual reports on the findings of the eight full scope inspections it undertook at major firms in 2008/9. Those reports were based on more detailed private reports on each inspection which it provided to the relevant Audit Registration Committee.

This is the second year that AIU reports on the findings of inspections of individual major firms have been made publicly available and is part of its programme to support the continuous improvement of audit quality. The reports are available from the FRC's website: <http://www.frc.org.uk/pob/audit/firmreports.cfm>. In the interest of accelerating the overall reporting timetable, reports on individual firms may be issued on more than two publication dates in future years.

In addition, the AIU has issued reports to the audit firms on the individual audit engagements reviewed at both the major and other firms which they are expected to make available to the directors of the relevant audit clients. The Oversight Board considers that these arrangements for reporting on the AIU's reviews of individual audit engagements, which took effect at the start of 2008, are making an important contribution to the transparency of reporting on the findings of the AIU's work and, ultimately, audit quality.

## **2.6 Impact of AIU inspections**

The AIU believes that its inspection process is both rigorous and challenging for firms and that the actions taken by the firms in response to its inspection findings in previous years have contributed to an improvement in the overall quality of audit work in the UK. This view is supported by feedback provided by the major firms to the FRC and the Oversight Board and by the results of follow-up reviews of individual audits undertaken by the AIU. The AIU is also aware of instances where the findings of its reviews of individual audits

have contributed to decisions regarding the composition of the audit engagement team, the remuneration of the audit engagement partner or the reappointment of the audit firm.

Notwithstanding this, the AIU continues to identify issues at each major firm both in relation to the policies and procedures supporting audit quality and individual audits. While the number of issues identified overall is generally lower than in prior years, the AIU remains concerned at the level of recurring issues.

The AIU notes that while firms respond in a positive manner to its inspection findings by altering their policies and procedures supporting audit quality or providing additional training to staff, such actions have not necessarily addressed the underlying causes of the issues. In the AIU's view, firms need to identify the underlying causes of recurring issues to enable them to take action that is likely to result in the behavioural changes required.

## **2.7 Public sector inspections**

Audits of public sector entities are not subject to audit regulation and therefore fall outside the scope of the AIU's inspections. In recognition of the contribution that independent inspection activities make to promoting and improving audit quality, the Audit Commission contracted the AIU to undertake annual inspections of its Audit Practice from 2007/8. From 2009/10 the Commission has also requested the AIU to extend the scope of its inspections to include those audits undertaken by the major accounting firms on their behalf.

The AIU also expects to undertake inspection activities at the National Audit Office ("NAO") in 2009/10. Previously the NAO was subject to inspection from 2001 by the ICAEW's monitoring unit.

The cost of these inspections is met by the bodies concerned. They are undertaken in the first quarter of each calendar year, the period in which the AIU undertakes less inspection fieldwork at the major firms. They therefore contribute to the overall efficiency and cost-effectiveness of the AIU's inspection activities as well as recognising the public interest in audits of public sector bodies.

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

## **2.8 Oversight of inspections by the professional bodies**

On behalf of the Oversight Board, the AIU undertakes certain oversight activities in relation to inspections undertaken at the other firms by the monitoring units of the

professional bodies. It approves the inspection methodology used to assess a firm's policies and procedures supporting audit quality and the assignment of inspectors to undertake this work. The AIU also approves the monitoring units' inspection reports on each firm.

## **2.9 International liaison**

Independent audit regulation continues to develop and expand internationally. As part of the FRC's ongoing commitment to liaise with other independent audit regulators, the AIU meets on a regular basis with other major independent audit regulators. It also participates in the International Forum of Independent Audit Regulators ("IFIAR") plenary meetings and audit inspection workshops. During 2008/9 the AIU also met and provided support to a number of other regulators who were in the process of developing their systems and methodology. The AIU considers that assisting other regulators in developing their inspection activities contributes to the AIU's overall objective of promoting audit quality.

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

## **3 AIU inspections 2008/9: major firms**

### **3.1 Introduction**

This section provides a summary of findings arising from the AIU's inspection work in 2008/9 at the eight major firms for which individual public reports have recently been published.

The AIU's public reports indicate that the senior management of these eight major firms have quality control procedures in place which are appropriate to the size of the firms and the nature of their client base.

While the AIU's public reports on individual firms seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm's client base. An issue included in these reports in relation to a particular firm might also apply to other firms. Only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

### **3.2 Principal findings**

Set out below is a summary of the principal findings arising from the AIU's inspections at the major firms. A number of these matters reflect the importance the AIU attaches to firms observing the principles underlying Auditing Standards and Ethical Standards as well as the specific requirements thereof.

#### *3.2.1 Audit challenges arising from the economic downturn*

The AIU reported last year that, on the basis of work undertaken in the latter part of 2007, it was satisfied that firms had responded appropriately at a firm-wide level to the audit challenges arising from what was then termed the "credit crunch". The AIU considers that firms generally continued to take appropriate action at a firm-wide level during 2008/9 to respond to increasing turmoil in financial markets and the onset of the economic downturn. Most firms issued significant additional guidance on a timely basis to audit personnel on key areas of increased risk relevant to their client base, such as the assessment of an entity's going concern status and the valuation of financial instruments in illiquid markets. Many firms also enhanced their audit procedures in key areas and/or strengthened their requirements for consultation with internal specialists or technical panels. However, some firms took appropriate action on a more timely basis than others.

The audits reviewed by the AIU during 2008/9 were mainly undertaken prior to the onset of the economic downturn. However, the findings of the AIU's reviews of individual audit engagements during 2008/9 indicated that the extent to which audit procedures were enhanced in practice varied both between firms and between individual audit teams. In particular, the AIU identified the quality and extent of audit evidence supporting the assessment of going concern as an area requiring improvement in a number of cases.

The AIU also considered, in the light of the additional risks arising from the economic downturn, that improvements were required to the procedures in place at some firms in relation to the extent of internal consultation and approvals required prior to accepting or continuing an audit engagement. Issues were also identified in relation to evidencing the processes performed in reaching a decision to accept or continue with an audit engagement.

The AIU will be reviewing whether the actions taken by firms at a firm-wide level during 2008/9 have resulted in an improved overall level of performance in key areas on audits reviewed during 2009/10. In relation to going concern, the AIU notes that firms should ensure that they identify and address risks arising where continued bank support is conditional on trading results or other matters.

The Oversight Board announced in March 2009 that the AIU would have particular regard during its 2009/10 inspections to audit issues relating to going concern, fair value accounting estimates and disclosures and the impairment of assets including goodwill and other intangibles.

### *3.2.2 Tone at the top*

The AIU found some evidence of firms increasing the emphasis on maintaining or improving financial performance in their explicit or implicit communications to audit personnel due to the current economic climate. This was apparent from the content of certain internal communications to audit personnel, the objectives set for certain audit personnel and bonus criteria. The AIU is concerned that this could lead audit personnel to believe that the importance certain firms place on quality, as opposed to maintaining or improving the financial performance of the firm, has been reduced. The AIU considers that a clear and consistent message regarding the overriding importance of high quality work should continue to be delivered by all firms to their audit personnel.

### *3.2.3 Performance evaluation*

The review of performance evaluation and remuneration policies and practices is an important aspect of an AIU inspection. A range of issues were identified across the firms,

including the emphasis placed on audit quality in assessing an individual's overall performance and whether there was a clear link to their level of remuneration.

The Ethical Standards do not permit firms to take account of success in selling non-audit services to audit clients in their arrangements for appraising, promoting and remunerating audit personnel. The AIU noted instances where appraisal documentation made specific reference to the cross-selling of non-audit services to audit clients. There was also some evidence that the term "selling" was being narrowly interpreted by firms in practice such that audit personnel were seeking recognition and reward for their contribution in obtaining non-audit work from their audit clients. The AIU considers that conveying a message within a firm, whether implicitly or explicitly, that audit personnel will be rewarded for their contributions to the firm obtaining non-audit work from their audit clients is not consistent with the underlying principles of the Ethical Standards.

#### *3.2.4 Non-audit services*

In 2008/9 the AIU continued to review whether the non-audit services provided by firms to their audit clients were permissible under the Ethical Standards and whether appropriate safeguards were in place to mitigate related threats to their independence and objectivity. Issues arising in this area during 2008/9 included the adequacy of safeguards implemented on the audit where the firm also provided advisory services to the client and inappropriate involvement by firms in the preparation of the financial statements, particularly in respect of current and deferred tax numbers for listed clients. The AIU considers that firms need to exercise greater care in assessing whether it is appropriate for them to provide certain non-audit services to audit clients, in identifying threats to their independence and objectivity and in assessing whether proposed safeguards are sufficient to reduce threats to an acceptable level.

If the Ethical Standards do not expressly address a particular non-audit service offered by a firm, the AIU expects firms to apply the underlying principles of the Standards in assessing whether it is appropriate to provide the service to an audit client. The Ethical Standards are principles-based and firms need to ensure that the underlying principles are observed.

The AIU will continue to give careful consideration to how firms are applying both the specific requirements and underlying principles of the Ethical Standards when providing non-audit services to audit clients.

#### *3.2.5 Long association with audit clients*

Auditor independence may be compromised by the familiarity threat arising from a long period of association in a senior role with a client. Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on

individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. For listed company audits, the audit engagement partner is required to rotate after having served for a maximum period of five years and “key partners involved in the audit”<sup>4</sup> (“KPs”) are required to rotate after seven years.

Issues relating to rotation policies and monitoring procedures were identified at most firms. These issues included whether specialists such as tax partners involved in major audits should have been identified as KPs and therefore been subject to rotation after seven years. The AIU notes that, while progress was made in this area in 2008/9, there remained considerable variation across the major firms in the identification of KPs on major audits.

At one firm the AIU noted that policies and procedures allowed an audit engagement partner to take on the role of client relationship partner after a cooling-off period of two years. While Ethical Standards are not explicit on the length of cooling-period required, the AIU’s interpretation is that for listed entities a five year cooling-off period applies.

### *3.2.6 Direct assistance by internal audit staff*

The AIU has previously commented on policies and practices at some firms involving the use of staff from a client’s internal audit department to perform external audit procedures directly for the audit team. It stated that firms should review the appropriateness of such policies and practices and what safeguards were necessary to address threats to auditor independence arising.

The AIU noted in 2008/9 that one firm had clarified its policies to restrict the use of internal audit staff to undertake external audit procedures to those areas not considered to give rise to a significant risk and where the application of significant judgment was not required. At three other firms, however, the AIU considered that policies in this area required further clarification. At one of these firms the AIU also concluded that the manner in which internal audit staff had been used on a particular audit reviewed was inappropriate. The AIU will continue to monitor closely the approach adopted by firms in this area taking into account any changes to relevant standards and related guidance.

### *3.2.7 Audit evidence and related judgments*

A key aspect of the AIU’s work is the review of significant audit judgments, including the rationale for accounting treatments, the reasonableness of assumptions used in valuations and accounting estimates, and judgments relating to the nature and extent of audit work

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<sup>4</sup> Key partners” are partners other than the audit engagement partner responsible for key audit decisions or judgments.

performed. The AIU was generally satisfied with the basis on which significant audit judgments were made on the individual audits reviewed. However, issues relating to the adequacy of the audit evidence obtained or the appropriateness of significant judgments made were identified at all firms. The areas in which issues arose included the recognition of certain provisions, the appropriateness of applying hedge accounting, the appropriateness of the carrying value of certain assets, the appropriateness of loan provisioning assumptions and the basis on which the work of experts was relied upon.

### 3.2.8 *Audit risks*

The AIU continued to identify deficiencies at the firms in relation to assessing and responding to audit risks, including fraud risks. Common issues included a lack of clarity over the identification of significant risks, a failure to evaluate the design and implementation of controls over significant risks and the approach to testing journals in response to fraud risks. While some firms had made progress in addressing shortcomings in this area, the AIU considers that further improvement is required at all firms. The revision of audit methodologies to reflect improvements to Auditing Standards which take effect for financial year-ends from December 2010 provides an opportunity for firms to ensure that their audit systems and guidance properly reflect the requirements of relevant Standards in this area.

### 3.2.9 *Communicating with audit committees*

The AIU considered the quality of reporting to audit committees by firms to be generally of a good or satisfactory standard. It also considered that relevant matters had generally been reported on a timely basis at both the planning and completion stages of the audit.

However, issues were identified regarding the quality of reporting on certain audits reviewed. These included inadequate reporting of significant audit findings or errors identified and insufficient reporting of independence threats arising from the provision of non-audit services and any related safeguards applied.

## **4 AIU inspections 2008/9: other firms**

### **4.1 Introduction**

This section provides a summary of the findings of the AIU's inspections at other firms who conduct audits of up to ten listed or other major public interest entities within the AIU's scope. The population of other firms may vary from year to year reflecting changes in both audit appointments and the AIU's scope. The other firms range in scale from larger national firms to smaller regional practices. A list of the other firms for 2008/9 is provided in Appendix A.

The AIU's inspections at other firms are limited to a review of one or more audits within the AIU's scope. The monitoring unit of the professional body with which the firm is registered reviews the firm's policies and procedures supporting audit quality.

Individual public reports are not issued on the findings of inspections at other firms. However, as with the major firms, the AIU issued reports on the individual audit engagements it reviewed at other firms. The AIU expects copies of those reports to be provided by the firms to the directors of the relevant audit clients.

In 2008/9 the AIU visited ten of the 36 other firms within the 2008/9 population listed in Appendix A and reviewed 13 individual audits, including two follow-up reviews. (In 2007/8 the AIU visited nine other firms and reviewed ten individual audits).

### **4.2 Principal findings**

The principal findings arising from the AIU's inspections at other firms are set out below. The issues raised are either considered to be individually significant or were common to a number of firms. The findings set out below are not intended to be representative of the quality of audit work undertaken by all the other firms listed in Appendix A. It is difficult to draw any general inferences about the quality of audit work at the full population of other firms, including in particular those firms which were not inspected by the AIU.

#### *4.2.1 Audit evidence and related judgments*

The AIU identified issues in relation to the adequacy of audit evidence on file to support certain account balances and related audit judgments on most of the audits reviewed at other firms. These included insufficient support for balances subject to uncertainty such as insurance recoveries and earn-outs, insufficient confirmations from banks and investment custodians and deficiencies in the audit of material inventory balances.

#### 4.2.2 *Group audits*

The other firms do not generally undertake audits of large or complex groups with material overseas subsidiaries, given the level of resources usually required to undertake such engagements. The AIU reviewed a number of group audits undertaken by other firms and, in relation to two of these audits, identified concerns regarding the firm's ability to undertake the audit satisfactorily.

The first case related to whether the firm's participation in the audit of a listed group was sufficient to enable it to act as principal auditor. In this case the majority of the audit work required for group purposes was undertaken outside the UK by another non-network firm and the firm had not undertaken any additional compensating procedures. The AIU considers that changes to Auditing Standards for group audits effective for December 2010 financial year-ends should result in firms not accepting appointment as group auditor in such situations in future without additional compensating procedures.

The second case related to the audit of a large private multinational company with significant operations in both the UK and overseas. The AIU considered that this audit was effectively undertaken as a joint audit with a major firm, although the statutory audit opinion was given only by the other firm. The overseas subsidiaries were audited by the major firm and the audit of the UK subsidiaries was shared between the firms on an "account balance" basis, with the other firm signing the UK statutory accounts audit opinion. While this arrangement was a reflection of the other firm's resource levels and had developed over time as the client had grown, in the AIU's view splitting the UK audit work in this way did not meet the requirements of Auditing Standards. The other firm concerned no longer acts as group auditor.

#### 4.2.3 *Using the work of an expert*

At five other firms the AIU identified issues in connection with the use of the work of experts engaged by clients to prepare accounting information, principally in relation to property and pension valuations. In the absence of any in-house expertise, it was unclear to the AIU how these firms were able to assess robustly the reasonableness of the assumptions used by the experts and to conclude on the appropriateness of their work as audit evidence. In the AIU's view it is insufficient for the auditor merely to discuss the work of the expert with them, particularly in the case of property valuations where the expert is in fact the directors. The audit files need to demonstrate how the firm satisfied itself, inter alia, that the assumptions used by the expert were reasonable and appropriate.

#### 4.2.4 *Independence issues*

The AIU identified a range of independence issues at other firms, most of which were similar in nature to those identified in prior years. The most common issue related to inappropriate involvement by firms in the preparation of the taxation figures for inclusion in the financial statements of listed entities. The AIU noted three instances of this. In one of these cases the issue was more prevalent with the firm also preparing the statutory accounts contrary to the requirements of the Ethical Standards for listed entities.

Long association with an audit client continued to be an issue. At one firm the AIU noted that the Engagement Quality Control Review partner had been involved with a listed client in varying capacities for a continuous period of 19 years, including a period as audit engagement partner. In the current year the partner had both undertaken audit work and attended Board meetings. In addition the audit engagement partner for the client had acted in that capacity for six years.

At another firm the AIU noted that the tax audit partner had been involved with a listed client for 20 years and the relationship partner, who was previously the audit engagement partner, had been involved with the client continuously for 15 years and continued to attend audit committee meetings.

In the AIU's view, the firm's independence and objectivity may have been compromised in both the above cases as a result of the length of involvement of these individuals.

At another firm the level of fees earned from a large private multinational company exceeded 10% of the firm's total fee income. An external Engagement Quality Control Reviewer had been engaged to mitigate the threats arising to the firm's independence and objectivity. This review was performed by a retired practitioner who had undertaken this role for 9 years. In the AIU's view, the reviewer did not have sufficient recent experience to provide an effective safeguard and had not identified a number of important issues on the audit.

#### 4.2.5 *Communicating with audit committees*

On four of the audits reviewed the AIU identified shortcomings in reporting to audit committees or other governance bodies which were consistent with those identified in prior years. These included not communicating significant findings from the audit in writing, not confirming the firm's independence and a lack of clarity as to whom the communications should be made. In the AIU's view the quality of reporting to those charged with governance remains an area requiring improvement at other firms.

#### 4.2.6 *Audit risks*

The AIU identified deficiencies in relation to the evidence on file demonstrating that audit risks including fraud risks had been appropriately assessed and responded to on all audits reviewed. Common issues included a lack of clarity over the identification of significant risks, insufficient consideration of fraud risks and a failure to evaluate the design and implementation of controls over significant risks. As noted in prior years, compliance with the requirements of the audit risk and fraud standards continues to be a challenge for other firms.

#### 4.2.7 *Going concern*

The quality and extent of evidence on file to support the assessment of going concern required improvement on six of the audits reviewed. However, many of these audits related to periods prior to the onset of the current economic downturn.

In the AIU's view other firms need to be more robust in their assessment of going concern. Directors should be asked to prepare formal documentation to support the going concern assumption, including forecasts that cover a period of at least twelve months from the date of approval of the financial statements. Audit files should evidence that the assumptions underlying the directors' forecasts have been subject to appropriate scrutiny.

In one instance the AIU noted that insufficient procedures had been undertaken in relation to the assessment of going concern of a UK subsidiary of an international bank. The statutory accounts of the UK subsidiary were approved nine months after the firm had completed its reporting for group purposes. Given the level of financing provided to the UK subsidiary by the parent company, and in light of the significant deterioration in the credit markets during that period, the AIU would have expected the firm to have been more robust in considering the impact of this on the parent company's ability to continue to provide support to the UK subsidiary.

## **5 Challenges facing auditors**

### **5.1 Introduction**

This section outlines a number of challenges facing auditors, many of which may be attributable to the economic downturn. The comments in this section are evolving issues and therefore do not relate specifically to matters identified as part of the AIU's 2008/9 inspection activities. The AIU will report on these matters as appropriate in 2009/10.

### **5.2 Economic climate**

The AIU notes that pressures on audit fees and therefore margins have increased significantly during the economic downturn. The AIU recognises that firms need to respond to these challenges and achieve efficiencies in the conduct of their audit work but, in doing so, they should guard against the short and long term risks to audit quality. Short term risks to audit quality include inappropriate reductions in the extent of audit procedures in order to achieve cost savings or placing additional demands on audit partners or senior staff. Any prolonged reduction in investment in audit, including recruitment, training or audit systems, or any inappropriate behavioural changes due to a realignment in personal objectives will have a long term impact on audit quality.

### **5.3 Changes to Auditing Standards**

The AIU notes that all firms will need to update their methodologies and/or audit support systems to reflect improvements to Auditing Standards due to take effect for December 2010 financial year-ends. The AIU recognises that the lead time required for developing and implementing new or improved audit support systems and methodologies on a global basis within the larger firms is very significant. In the AIU's experience such new or improved audit support systems and methodologies generally represent significant improvements over the systems they replace. The AIU therefore considers that, notwithstanding the current economic climate, firms need to maintain a significant level of investment in this area to ensure that the changes required to implement the revisions to Auditing Standards and other necessary improvements to their systems are delivered on a timely basis. The AIU will be closely monitoring progress in this area during its 2009/10 inspections.

### **5.4 Fraud risks**

The economic downturn increases the risk of significant fraud occurring in companies whose financial performance is under pressure. While Auditing Standards contain a number of requirements designed to ensure that the auditor gives appropriate

consideration to such risks, as noted in sections 3 and 4 this is an area where the AIU considers that further improvement is required at all firms. The AIU urges firms to consider the adequacy of their fraud risk assessment procedures in light of the economic downturn, including whether the risks associated with revenue recognition policies are being properly assessed by audit teams.

## **5.5 Going concern**

As a result of the economic downturn a significant number of companies have found it necessary to raise additional capital and/or to refinance their borrowings. As a consequence firms are increasingly being asked to provide assistance to their clients in connection with their refinancing activities. Without this refinancing, the going concern assumption may be called into question for some clients.

The AIU notes that if refinancing is directly linked to a firm concluding positively on the going concern assumption, it is likely that providing non-audit services to assist the refinancing process will give rise to a number of threats to the auditor's objectivity. Audit issues related to going concern are an area of focus of the AIU's 2009/10 inspections.

## **5.6 Impairment of goodwill and other intangibles**

The current economic downturn increases the likelihood that goodwill and other intangibles will be impaired as the key assumptions used in assessing potential impairment (such as the level of cash flows and growth rates) may need to be revised downwards significantly. The AIU notes that for some entities goodwill represents a significant proportion of their total assets. As a result of decreasing market values, the market capitalisation of certain entities has fallen below the value of their net assets including goodwill and other intangibles. As part of its 2009/10 inspections, the AIU is focusing on the quality of audit evidence obtained by firms to support their audit judgments relating to the potential impairment of goodwill and other intangibles, including the robustness of challenges to the reasonableness of key assumptions such as future growth rates and the choice of an appropriate discount rate.

## **5.7 Valuation of assets held at fair value**

The current economic downturn has caused significant reductions in the valuation of assets held at fair value, including investment properties, other investments and pension fund assets and liabilities, and resulted in increasing challenges for auditors in areas such as the valuation of financial instruments in illiquid markets. As part of its 2009/10 inspection activities the AIU is focusing on the quality of audit evidence obtained by firms to support judgments in relation to the fair value of assets, including the methods of valuation, the assumptions used and the basis for reliance on the work of experts.

## **5.8 Determination of materiality**

The determination of materiality is a key judgment when planning an audit. Auditing Standards are not prescriptive in this area. Firms adopt differing approaches to the determination of materiality, with differing bases and acceptable ranges in which judgments should be made. The economic downturn has resulted in significant variations in financial performance between reporting periods. This raises questions over how significant losses and one-off costs such as those relating to impairments and restructuring should be treated for the purposes of calculating materiality. The AIU expects that in calculating materiality, for the purpose of determining the extent of audit procedures and evaluating the effect of misstatements, firms will give appropriate consideration to the impact of losses and significant one-off items. Firms should also ensure that the rationale for the chosen level of materiality is clearly articulated on audit files.

## **5.9 Group audit arrangements**

The attractiveness of London as a financial centre results in a number of UK companies listing in London which undertake very limited activities in the UK. This can give rise to complex audit arrangements under which the audit opinion on the group financial statements is the responsibility of a UK statutory auditor but in practice the majority of the group audit work is undertaken by other firms, usually based outside the UK and not necessarily part of the same network. The AIU expects the group auditor to ensure that they have sufficient involvement in the audit and that they obtain appropriate reports from other auditors undertaking work for group audit purposes. In addition, the group auditor should ensure that their own files contain sufficient audit evidence to support the group audit opinion.

## Appendix A – List of other firms

The AIU undertakes an annual exercise to identify other firms (those firms that audit up to ten listed or other major public interest entities within the AIU's scope as defined in Appendix B). For the 2008/9 inspection cycle this exercise, which was undertaken as at the start of the period, identified 36 other firms as set out below. Ten of these firms were selected by the AIU for inspection in 2008/9. All of the firms are registered with the ICAEW, with the exception of Chiene & Tait, French Duncan LLP and Scott Moncrieff who are registered with the ICAS.

The findings of the AIU's 2008/9 inspections set out in section 4 are not intended to be representative of the quality of audit work undertaken by all the other firms listed below. It is difficult to draw any general inferences about the quality of audit work at the full population of other firms, including in particular those firms which were not inspected by the AIU.

Beever & Struthers	Littlestone Martin Glenton
Begbies Chettle Agar	Mazars LLP
Chantrey Vellacott DFK LLP	Menzies
Chiene & Tait	Moore Stephens LLP
CLB Coopers	Nexia Smith & Williamson
Cooper Parry LLP	PRB Martin Pollins LLP
Elman Wall Limited	Rees Pollock
Everett & Son	Royce Peeling Green Limited
French Duncan LLP	Saffery Champness
Hawsons	Scott Moncrieff
Haysmacintyre	Shipleys LLP
Hazlewoods LLP	Smith Cooper Nottingham
Howsons	Spofforths LLP
Hurst & Company Accountants LLP	Steele Robertson Goddard
James Cowper	Tenon Audit Limited
Kingston Smith LLP	UHY Hacker Young LLP
Knox Cropper	UHY Hacker Young Manchester LLP
Littlejohn	Whittingham Riddell LLP

## Appendix B – Scope of independent inspections 2008/9

Audits of the following entities were within the scope of the AIU's inspections in 2008/9.

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

For the avoidance of doubt, UK incorporated companies excludes companies incorporated in the Crown Dependencies.

The above criteria were applied as at the start of the period in identifying entities within the AIU's scope for its 2008/9 inspections. Further details relating to the AIU's scope of inspections, including the criteria applied for the 2009/10 inspections, is available on the FRC's website: <http://www.frc.org.uk/pob/press/pub1905>.



**FINANCIAL REPORTING COUNCIL**

**5TH FLOOR**

**ALDWYCH HOUSE**

**71-91 ALDWYCH**

**LONDON WC2B 4HN**

**TEL: +44 (0)20 7492 2300**

**FAX: +44 (0)20 7492 2301**

**WEBSITE: [www.frc.org.uk](http://www.frc.org.uk)**

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Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.