



## **AUDIT INSPECTION UNIT**

# **PUBLIC REPORT ON THE 2008/9 INSPECTION OF GRANT THORNTON UK LLP**

**5 NOVEMBER 2009**

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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# 1 Scope, objectives and background information

## 1.1 Introduction

This report sets out the principal findings arising from the inspection of Grant Thornton UK LLP (“Grant Thornton” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), part of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2009 (“the 2008/9 inspection”). Our inspection was conducted primarily in the period from June 2008 to December 2008 (referred to as “the time of our inspection”). This is the second year the AIU has reported publicly on individual firms.

It is based on the AIU’s more detailed private report on its inspection of the firm to the Audit Registration Committee (“the ARC”) of the Institute of Chartered Accountants in England and Wales (“the ICAEW”) with whom the firm is registered for audit purposes. The AIU currently inspects the largest audit firms, including Grant Thornton, annually<sup>1</sup>. The 2008/9 inspection was the AIU’s fourth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2008/9 report to the ARC, which was finalised in June 2009, recommended that the firm’s registration to conduct audit work should be continued.

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

The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm’s client base. An issue reported in relation to a particular firm may apply equally to other firms without having arisen in the course of the AIU’s inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm’s audit work.

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

All the findings requiring action set out in this report have been discussed with the firm, together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU during its next inspection of the firm.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there is necessarily a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The firm was invited to provide a letter of comment on this report. The firm's response is set out in Appendix A.

The AIU acknowledges the co-operation and assistance received from the partners and staff of Grant Thornton in the conduct of the 2008/9 inspection.

## **1.2 Scope and objectives**

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing to this aim is for the users of audit reports to be able to place a high degree of reliance on audit opinions, including whether financial statements show a true and fair view. The AIU's programme of inspections is designed to contribute to the achievement of this strategic outcome.

Our inspections of the major audit firms, on which we report publicly, comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board.

We review firms' policies and procedures in the following areas:

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

Our reviews of individual audits place emphasis on the appropriateness of significant audit judgments exercised in reaching the audit opinion as well the sufficiency and appropriateness of the audit evidence.

Our inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)<sup>2</sup> and other relevant requirements under the ICAEW's Audit Regulations<sup>3</sup>. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.

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

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. Our inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

We reviewed the quality of seven individual audit engagements undertaken by the firm in our 2008/9 inspection. These related to FTSE 250, other full listed and other major public interest entities, with financial year ends between December 2007 and March 2008, the majority of which were March 2008. Our reviews covered selected aspects of the audit only. In addition we undertook one follow-up review to assess the extent to which our prior year findings had been addressed in the following year's audit.

The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within

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<sup>2</sup> International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

<sup>3</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 scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange (“a full listing”) and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

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

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

### **1.3 Background information on the firm**

The firm is a UK limited liability partnership. It is the UK member of Grant Thornton International, a global network of firms using common audit methodology and audit software.

At the time of our inspection the firm was organised into four market-facing business units, two of which delivered assurance services including audit from offices in some 30 locations nationwide. Technical Communities, including the one for assurance (‘Assurance’), were responsible for technical standards and quality control mechanisms.

For the year ended 30 June 2008, the firm’s turnover was £394 million, of which £117 million related to Assurance<sup>4</sup>. The average number of partners was 306 and of other professional and support staff was 3,965. At 1 January 2009, 101 partners and 20 employees were authorised to sign audit reports<sup>5</sup>.

The AIU estimates that firm had 117 audit clients within the scope of independent inspection by the AIU as at the 2008/9 reference date of 28 February 2008. Of these audit clients, AIU records show that 102 had a full listing or were listed on the AIM market of the London Stock Exchange<sup>6</sup>, including five FTSE 250 audit clients.

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<sup>4</sup> As disclosed in the firm’s annual report for the year ended 30 June 2008. An analysis of Assurance turnover between audit and non-audit fees is not publicly available.

<sup>5</sup> As disclosed in the annual return to the ICAEW as at 1 January 2009.

<sup>6</sup> The firm also had other AIM listed audit clients below the threshold for inclusion within the AIU scope.

#### **1.4 Reporting on AIU reviews of individual audit engagements**

The AIU introduced new reporting arrangements in respect of its reviews of individual audit engagements commencing from 2008, with the objective of increasing transparency and meeting the increased expectations of stakeholders. This involved issuing new letter style reports on audits reviewed by the AIU. Although addressed to the relevant audit engagement partner or director, the Oversight Board expects firms to provide copies of these reports to the directors of the relevant clients.

## 2 Findings

### 2.1 Overview

Our review of the strategies and communications, both of the firm and of Assurance, demonstrated the importance the firm continues to place on audit quality.

In our view, the firm has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas which are subject to our review. A positive development in 2008 was the introduction by Assurance of audit quality measures to be taken into account in appraisals, remuneration and promotion decisions of audit partners and staff for the year ending 30 June 2009. In our view, the introduction of these measures is likely to make a positive contribution to audit quality. We identified certain areas for improvement in relation to the firm's policies and procedures, including the completion of audit partner and staff appraisals and personal development plans, as set out in sections 2.2 to 2.4 of this report.

In relation to reviews of individual audits, we have generally reported our findings by reference to significant matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

We were generally satisfied, subject to our comments in section 2.4.3, with the basis on which significant audit judgments were made on the seven audits reviewed by us. In our view, audit procedures were generally performed to a good or acceptable standard. The overall findings arising from our review of individual audits are set out in section 2.4; these include areas where improvements are, in our view, needed in order to enhance audit quality.

The follow-up review we conducted showed that the issues raised in our review the previous year had been addressed on that audit.

While the majority of the overall findings raised in our prior year report had been appropriately addressed, a number of our findings remained outstanding. The firm had action plans in place to address all the outstanding findings.

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

## 2.2 Quality control

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

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

### 2.2.1 *Leadership, strategy and communications*

#### *Leadership*

The day to day management of the firm is the responsibility of the National Leadership Board whose activities are monitored by the Partnership Committee. The National Leadership Board is chaired by the Chief Executive Officer. His responsibilities include ensuring the firm operates within the Statement of Principles established by the Partnership Committee. The Statement of Principles includes objectives relating to quality.

A new Chief Executive Officer took office on 1 January 2009. Some changes in the organisation and management of the firm effective from that date were announced in late 2008.

#### *Strategy*

Under the new leadership, the firm's mission is stated to be building a resilient and highly profitable business by pursuing leadership in its core market and selected niche markets through the qualities of its people, international capabilities, industry specialisms and a "one-firm approach". During 2008 a new articulation of the values of Grant Thornton International was finalised for use by the firms in the global network including the UK firm. One of the five values is the promotion of a consistent culture of excellence including the achievement of the highest standards of quality.

A new strategy for Assurance was launched in 2008. One of the four strategic priorities is audit quality with the goal to "continue to raise the quality of all audit processes and training through continuous improvement".

### *Reduction in number of persons authorised to sign audit reports*

A reduction of about 13% in the number of partners and employees authorised to sign audit reports and undertaking audit engagements was planned over the year ending 30 June 2009. The Head of Assurance informed us that he had satisfied himself that this reduction would have no adverse impact on audit quality. We will assess whether this has had any adverse impact on audit quality in practice in our next inspection.

### *Communications on audit quality*

We reviewed a selection of key communications from the firm's leadership and the leadership of Assurance to audit personnel relating to audit quality. It is clear that audit quality is regularly emphasised, both explicitly and implicitly.

The firm published a Transparency Report in October 2008 on its website, in advance of the statutory requirement to do so.

### *2.2.2 Performance evaluation, promotions and remuneration*

#### *Performance evaluation*

Periodic appraisals are carried out twice a year for staff and once a year for partners. The appraisal process which we reviewed included annual rating of performance in relation to various personal, business and client service attributes. There was guidance on how certain of these attributes should be assessed from the standpoint of audit quality. No overall performance rating was made. In addition, performance against business objectives set at the last review was assessed, business objectives were established for the next period and a personal development plan was agreed.

The firm planned to replace the attributes mentioned above by competencies set out in a new competency framework in 2009, and to introduce an overall performance rating. Furthermore, performance evaluation in 2009 will cover achievement of the audit quality measures introduced in 2008. The criteria for measuring audit quality have been based on the five drivers of audit quality set out in the FRC's Audit Quality Framework.

We reviewed a sample of appraisal forms of audit partners, directors and managers. We found that, generally, they had been completed to a satisfactory standard; however, explicit reference to audit quality in both the appraisal and/or business objectives sections was variable. In addition, as in the previous year, we found that the appraisal process was not being completed on a timely basis in all cases. The need for action in this area has been recognised by senior management.

### *Promotion to partner*

The process for promotion to audit partner entails the preparation of a sponsoring partner's report, candidate self assessment, psychometric testing and interviews and includes a focus on audit quality. In our view, the process is satisfactory.

### *Remuneration*

Audit partners are graded in relation to audit quality and these grades have an impact on equity audit partner remuneration. The audit quality grades were introduced in 2007 and impacted on equity audit partner remuneration in 2008. In our view, this was a positive development.

At the time of our inspection, the salary review process for staff was not directly linked to the appraisal process but we were informed that this will change in 2009.

### *2.2.3 Other human resources matters*

#### *Audit training and technical communications*

A full range of technical and personal skills training is provided to Assurance personnel. In addition the firm disseminates technical material during the year by way of a series of technical bulletins. We reviewed several technical bulletins and some course outlines and presentations and were satisfied with the content of them.

Technical updating in audit and accounting matters, changes in audit methodology and areas identified as needing improvement is given by way of national training courses in the autumn, supplemented by six monthly updates provided by an external provider. Attendance at these courses by audit partners, managers and qualified staff is mandatory. Attendance at training events is monitored locally. For certain critical courses, attendance is also monitored and followed-up centrally.

We reviewed a sample of Personal Development Plans ('PDPs') and of Continuing Professional Development ('CPD') reports of audit partners, directors and managers. PDPs are normally prepared as part of the appraisal process and CPD reports contain details of professional development activity undertaken subsequently. There was a full complement of CPD reports which showed that in all cases all the mandatory and other relevant technical update courses had been attended. However, there were no PDPs for a significant proportion of the sample.

### *Communications and other actions relating to the economic downturn*

Audit personnel have been alerted to, and received guidance on, the audit risks arising from the economic downturn and the need to address issues arising appropriately. In our view, this guidance was appropriate and provided in a timely manner.

The firm has introduced a short going concern questionnaire to be completed for all audits. This generates an assessment of the going concern risk of the client. In the case of higher risk ratings a detailed file note must be prepared to support the firm's proposed actions and this must be signed off by the Office Audit Partner.

In late 2008 each office was asked to identify its audit clients most at risk from the financial crisis. The objectives of the project were to manage the firm's exposure to clients considered to be at risk and to assist the clients through the crisis within the constraints of the Ethical Standards.

### *'Badging' of audit partners*

Partners are allocated to audit clients on the basis of, inter alia, their knowledge and experience. For certain categories of higher risk audit clients: listed companies, charities and not-for-profit bodies, pension schemes and professional practices, partners are 'badged', that is licensed by the firm, to act on those audit clients. In our view, this licensing approach should contribute to audit quality.

### *2.2.4 Client risk assessment and acceptance / continuance*

Firms are required to have policies and procedures in place to provide them with assurance that client integrity, compliance with ethical requirements and their competence, capabilities and resources are considered before they decide whether to accept or continue an audit engagement<sup>7</sup>.

Grant Thornton allocates each audit client to one of seven risk categories, A to G, largely reflecting its public profile. All listed entities are allocated to category A, the highest risk category. These risk categories determine the nature of the acceptance approval, the required 'badge' of the audit partner, the need for a review partner and his/her required 'badge' and the level of tax department involvement.

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<sup>7</sup> International Standard on Quality Control (UK and Ireland) 1, paragraph 28.

For each new client or assignment, the acceptance process includes a risk assessment, consideration of independence and potential conflicts of interest and requires approval by the Office Managing Partner and, in certain cases, at a more senior level in the firm.

Audit partners are required to formally consider client retention at the planning and completion stages of the audit. Depending on the risk assessment generated by the automated process, the continuance decision may need approval at a higher level in the firm.

We reviewed the firm's client risk assessment and acceptance and continuance policies, procedures and documentation, including a sample of completed audit acceptance and continuance forms, and considered that they were satisfactory.

#### *2.2.5 Consultation and review*

Firms are required to have policies and procedures in place requiring an engagement quality control review to be undertaken for all audits of financial statements of listed entities and other audits meeting specific criteria<sup>8</sup>.

##### *Engagement Quality Control Review*

An independent review partner, equivalent to an engagement quality control reviewer, is assigned to the audits of publicly traded entities, unit trusts and open-ended investment companies and similar investment entities. The independent review partner is required to have no contact with the client.

A review partner (who performs a similar role to an independent review partner but who may have contact with the client) is assigned to most of the firm's other audits in higher risk categories.

We reviewed the evidence of application of the independent review partner and review partner procedures as part of our review of individual audits. There were no issues arising from our review.

##### *Pre-issuance technical reviews*

The financial statements of publicly traded audit clients, unit trusts and open-ended investment companies and similar investment entities and certain charities and other not for profit organisations are subject to an independent technical review by the firm's

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<sup>8</sup> International Standard on Quality Control (UK and Ireland) 1, paragraph 60.

National Assurance Services department, or by the Financial Services Group in the case of managed funds, before they are issued. The firm has decided to extend this review requirement to the financial statements of other public interest entities as defined by the firm for audit reports signed after 30 September 2009.

For listed clients, the review is performed before the issue of the preliminary announcement. All major points must be cleared before the preliminary announcement is made or, if a preliminary announcement is not required, before the financial statements are approved.

The pre-issuance technical reviews relating to the individual audits reviewed by us were performed to a satisfactory standard.

#### *2.2.6 Audit quality monitoring*

Firms are required to have monitoring procedures in place, including reviews of a selection of completed audit engagements, to provide them with assurance that their system of quality control is adequate, operating effectively and complied with in practice. Such monitoring is required to be undertaken at least annually<sup>9</sup>. The firm refers to these monitoring procedures as the National Audit Review ('NAR') and this terminology is used in this report.

Under the NAR, each office is reviewed every three years or, if deemed necessary, more often than this. At least one audit for each audit partner or employee in those offices who is authorised to sign audit reports is selected for review. In addition, an audit for each person newly authorised to sign audit reports located in other offices is reviewed as part of the NAR. The NAR focuses on the quality of the audit work of the offices under review but also covers the application of certain office procedures. Audits are graded 1 ('Poor') to 5 ('Excellent'), with 3 being 'Standard expected'. The main fieldwork of the NAR is carried out in September and October by senior audit personnel independent of the office under review. The findings of the NAR are disseminated to the audit practice by way of various media.

The NAR is a UK process independent of the audit quality monitoring carried out by Grant Thornton International ('GTI') on member firms. A GTI review of the UK firm is carried out periodically; the most recent review took place in January 2007.

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<sup>9</sup> International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations.

The 2007 NAR covered five offices/ business units and all personnel signing audit reports and all audit managers in those offices. In total 131 audits were reviewed. At the time of our inspection the 2008 NAR was underway.

Based on our review of the NAR process and supporting documentation, we considered that the 2007 NAR appeared to have been well planned and, on the whole, well executed, that follow up actions in respect of the offices reviewed were appropriate and that the findings arising had been disseminated to the audit practice in a timely manner. However, the 2007 NAR reports at both firm and office level did not make it clear what specific action was taken in cases where audit files were graded 'poor'.

## **2.3 Independence and ethics**

### *2.3.1 Ethical policies and consultation*

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

Following the issue of the revised Ethical Standards in 2008, there have been a number of changes to the firm's policies and procedures, in particular in respect of unlisted public interest entities as defined by the firm.

The prescribed process of consultation for audit personnel starts at the local level. Since July 2008 queries directed to and responded by the National Ethics team have been logged in a central e-mailbox and sorted by subject matter. We have been informed that it is planned to establish a case management system by 30 June 2010 to capture all ethical consultations directed to the centre, monitor their progress and record their resolution, all on a central database.

### *2.3.2 Compliance monitoring procedures*

There are four main strands of central ethical compliance monitoring for Assurance personnel.

The Annual Regulatory Statements and Declarations made by individual partners and staff include completion of fit and proper and independence questionnaires. Any exceptions reported by individuals in Assurance are reviewed by their Office Managing Partner and by the central compliance function. Our review of the process indicated that no significant issues arose.

Office Managing Partners are required to submit an Annual Ethics Compliance Report on ethics and independence procedures performed locally. We reviewed the effectiveness of the process and its findings; no issues of significance were reported.

Certain office procedures are reviewed as part of the NAR process. There were no systemic matters arising in the 2007 NAR.

The Global Independence System ('GIS') records the quoted audit clients of GTI member firms and the quoted parent companies of significant subsidiaries that are audit clients of GTI member firms, together with the financial interests of partners and managers of GTI member firms. GIS is used by the National Ethics function to monitor compliance by the firm's partners and managers with the firm's independence requirements relating to financial interests.

### 2.3.3 *Rotation policies and monitoring*

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. For listed company audits, the engagement partner and engagement quality control reviewer are required to rotate after having served for a maximum period of five years and key partners ('KPs') are required to rotate after seven years<sup>10</sup>.

The firm applies the above partner rotation requirements for listed company audits to all publicly traded entities, unit trusts, open ended investment companies and other similar investment entities. In addition, with effect from accounting periods starting on or after 1 January 2009, the firm has decided to enhance its partner rotation requirements applicable to unlisted public interest entities as defined by the firm.

It is the firm's policy that periods of involvement with an audit client at different levels of seniority are not aggregated for the purposes of assessing threats arising from long association with the client and the need to apply safeguards. In our view, this policy should be re-considered in the light of the principles underlying the Ethical Standards.

Up to the end of 2008, the firm had identified no one who fell into the categories of either KPs or other partners and staff in senior positions ('OPSS') on audits. Following the issue of the revised Ethical Standards the firm has issued more guidance on the identification of KPs and OPSS on audits.

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<sup>10</sup> APB Ethical Standard 3 (Revised), paragraphs 5, 6, 12 and 18. "Key partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

In order to improve monitoring of compliance with rotation and other long association policies, National Ethics launched a central database in October 2008, in place of the previous central spreadsheet, containing relevant details relating to audit clients in the higher audit risk categories. Responsibility for maintaining the database lies with Office Audit Partners. This database did not include details of KPs and OPSS at the time of our review. We were informed, however, that the firm planned to make the necessary changes to the database to enable such information to be captured. In the meantime, audit teams have been instructed to gather such information and include it in the audit file.

Long association with audit clients in the low risk category is monitored locally.

## **2.4 Audit performance**

This section covers findings arising from our review of the firm's audit methodology and our review of individual audits, including recurring instances of non-compliance with the firm's audit methodology, under the following headings:

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

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

### *2.4.1 Audit methodology*

The firm uses the audit methodology developed by GTI. The firm is actively involved in its development. Following the introduction of International Standards on Auditing (UK and Ireland), the firm tailored the audit methodology and the associated audit software to reflect the additional requirements of the UK standards. In our view, the firm's audit methodology and associated audit software, if properly applied, are generally sufficient to enable compliance with Auditing Standards.

The firm is introducing revised audit methodology and new audit software on a phased basis, office by office, during 2008 and 2009. It is planned to complete the change-over by the end of December 2009. The firm is carrying out a detailed mapping of the revised audit methodology and the new audit software to the International Standards on Auditing (UK and Ireland) in 2009.

The audit software used by audit teams to document, evaluate and test internal control systems will be an integral part of the new audit software platform.

#### *2.4.2 Assessing and responding to risk*

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including which of these risks require special audit consideration (such risks are termed “significant risks”)<sup>11</sup>. A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

The process used to identify significant risks focuses on standard transaction cycles. As in our previous inspection, we found that the design and implementation of controls over significant risks outside the standard transaction cycles were not evaluated in all cases. Examples we identified included the impairment of goodwill and the recognition and impairment of other intangible assets. Often these areas arise at the group or parent company level. We were informed that this issue should be addressed by the introduction of the revised audit methodology and new audit software.

We reviewed the audits of two investment trusts. In both cases the activities of the trust are outsourced to service organisations and, as a result, audit work was performed in relation to assessing and responding to audit risks arising in the outsourced activities. In our view, further tailoring of the firm’s audit software would have enhanced the effectiveness of the audit work performed. We were informed that the new audit software currently being introduced facilitates audit work in this area.

#### *2.4.3 Audit evidence and related judgments*

We were, subject to our comments below, generally satisfied with the basis on which significant audit judgments were exercised on the seven individual audits reviewed.

##### *Evidencing of audit work*

We had particular concerns about the quality of evidencing the audit work in three audits. The audit files did not contain sufficient appropriate audit evidence or record the audit team’s reasoning in support of certain audit judgments made and the conclusions reached. As regards all three audits we had to rely to a large extent on the audit team’s oral explanations and/or evidence not included on the audit files to determine the audit work performed and the evidence obtained.

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<sup>11</sup> International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108.

### *Review of journal entry controls*

In two audits, completion of the firm's standard programme on the review of journal entry controls was, in our view, inadequately evidenced.

### *Audit of contracts*

In one audit the majority of the significant risks related to contract balances and revenue, including profit recognition, and a substantial amount of work was performed in this area. In our view, however, there was scope for improvement in the planned audit approach and certain areas of the work performed in relation to contract balances and revenue, in particular as regards covering certain aspects of completeness of contract costs and analysing and concluding on the quality of budgeting and forecasting at the contract level.

### *Review of actuarial assumptions*

In one audit, we found no evidence on the audit file of consideration of the actuarial assumptions underlying the valuation of the defined benefit pension assets and liabilities to support the conclusion that the assumptions were reasonable (in particular, the salary inflation assumption which was significantly below the level suggested by the firm's guidance).

### *Analytical procedures*

In three audits we found deficiencies in the analytical procedures used to obtain audit evidence. In one case, the audit expectations set by the audit team were not explained or justified. In one case, acceptance thresholds, being the amounts of variance from expectations that can be accepted without investigation, were not established. In two cases, management explanations for variances from expectations were not corroborated.

### *Sampling*

In three audits, calculations or justification of the sizes of certain samples selected for testing or details and justification of the method of sample selection were not included in the audit file. In our view, such justification is necessary in order to ensure that the auditor obtains sufficient and appropriate audit evidence.

#### 2.4.4 *Communicating with Audit Committees*

Auditing Standards require the auditor to communicate matters of governance interest arising from the audit with those charged with governance of the entity. Such communications will usually take place with an Audit Committee or similar body acting on behalf of the Board<sup>12</sup>. Appropriate communication with the Audit Committee or other relevant governance body contributes to the quality of the audit and assists both parties to discharge their responsibilities effectively.

We found that the reporting to Audit Committees in respect of the audits reviewed was generally of a satisfactory standard. However, in the case of two audits, in our view, more specific information should have been reported to the Audit Committee about the audit approach to internal controls and the findings from the audit work performed.

In one audit, not all the unadjusted audit differences in excess of the amount designated as being clearly trivial were reported in writing to the Audit Committee and included in the summary of unadjusted audit differences.

#### 2.4.5 *Audit Finalisation*

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

Generally we found that such procedures had been performed to an acceptable standard. In two audits, although going concern was not considered to be an area of high audit risk, there was, in our view, insufficient evidence on the audit file that cashflow forecasts for a full twelve month period after the date of the audit report had been considered.

5 November 2009

END OF REPORT

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<sup>12</sup> International Standard on Auditing (UK and Ireland) 260, paragraph 11.

## **Appendix A – Firm’s response**

**The Firm’s response is on the next page**



# Grant Thornton

Audit Inspection Unit  
Aldwych House  
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29 October 2009

Dear Sirs

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## **Public report on the 2008/9 inspection of Grant Thornton UK LLP**

We write to provide our response to the Audit Inspection Unit's (AIU's) Public Report on the 2008/9 inspection of Grant Thornton UK LLP (the Report). We continue to be supportive of independent public reporting of the quality of auditing by UK accounting firms as a positive contributor to confidence in the value of audited financial statements.

As last year, we are very pleased that the Report concludes that the firm has policies and procedures in place in all areas reviewed that are appropriate for the firm's size and the nature of the firm's client base. The Report also recognises that the changes that we have made during 2008/9 are positive developments that are intended to contribute to audit quality. These observations provide independent validation of our commitment to audit quality.

It is also pleasing that the Report concludes that the audit procedures on the files reviewed were "generally performed to a good or acceptable standard" and therefore the audit reports are supported. Although the Report contains findings in respect of certain audits, we are pleased to note that no audits have been described as requiring significant improvement.

The Report includes a number of findings which we have already addressed and we have plans in place to address the remaining matters. We recognise that maintaining audit quality in a challenging business environment requires continuous review of audit processes and the way in which they are applied in practice. The findings of our internal audit quality monitoring programme, reviews performed by Grant Thornton International and reviews performed by audit regulators (including the QAD, PCAOB and AIU) all provide valuable insights into areas where improvements can be made.

We would like to thank the AIU for the constructive manner in which it conducts its reviews.

Details of our approach to audit quality are set out in our Transparency Report, which may be accessed at

[http://www.grant-thornton.co.uk/about\\_us/transparency\\_report\\_2009.aspx](http://www.grant-thornton.co.uk/about_us/transparency_report_2009.aspx)

Yours faithfully

### **Chartered Accountants**

Member firm within Grant Thornton International Ltd  
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A list of members is available from our registered office.

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