



**AUDIT INSPECTION UNIT**

**2004/5 AUDIT QUALITY INSPECTIONS**

**PUBLIC REPORT**

**JUNE 2005**





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**This report is issued by the Audit Inspection Unit (AIU) of the UK's Professional Oversight Board for Accountancy (POBA). It has been approved for publication by the POBA Board. The POBA 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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## One - Overall Conclusions

This section of our report sets out the overall conclusions drawn by the Audit Inspection Unit (AIU) of the Professional Oversight Board for Accountancy (POBA) from the inspection work carried out at the four largest UK audit firms (Deloitte & Touche LLP, Ernst & Young LLP, KPMG Audit Plc and PricewaterhouseCoopers LLP) in the period from June 2004 (when on-site work commenced) to 31 March 2005. These conclusions should be read in the context of our report as a whole which explains the overall objective of our work, how our monitoring approach reflects this objective and the principal issues arising from our work.

Our monitoring approach is intended to be more challenging than in the past, focusing on judgments as well as audit processes. Our reviews of individual audit engagements indicated that the key audit judgments exercised in relation to financial reporting issues appeared, in the great majority of cases, to be both appropriate and soundly based. However, as a result of insufficient documentation, it was often necessary to form a view as to the appropriateness of such judgments on the basis of oral explanations provided to us. Insufficient audit documentation both reduces the effectiveness of firms' own quality control processes and makes it more difficult to adopt a monitoring approach focusing on key audit judgments (rather than an approach characterised by some as "box ticking"). We referred two cases to the FRC's Financial Reporting Review Panel, where we considered that there was sufficient doubt as to whether the accounting treatment adopted and/or disclosures provided complied with UK GAAP (the issues concerned did not affect reported profits in either case).

Our inspections identified no systemic weaknesses in the overall policies, procedures and systems of quality control operated by the firms and indicate that, when properly applied, those procedures and systems should provide reasonable assurance that appropriate audit opinions are issued by the firms. However, we have identified certain areas in which we consider that improvements to these policies, procedures and systems, and/or the application thereof, should be made, either to achieve compliance with relevant standards or to enhance audit quality.

We believe that the risks the above matters pose for the quality of individual audit engagements should be addressed by the firms. We are in the process of making a number of recommendations to each of the firms in their private reports as to the actions we believe are appropriate to address the issues arising from our work. We expect the firms to implement our recommendations on a timely basis, taking account of our prioritisation of the relevant issues. We will review the extent to which they have done so during our 2005/6 inspections and report on this in our next public report in a year's time.

## **Two - Introduction**

### **2.1 Overview**

This report covers the work undertaken by the Audit Inspection Unit (AIU) of the Professional Oversight Board for Accountancy (POBA) in the period to 31 March 2005 and the principal issues arising from our work. On-site monitoring work by the AIU commenced at one of the Big 4 firms in June 2004 and, by November 2004, inspections were in progress at all of the Big 4 firms.

The nature of the AIU's monitoring approach means that inspections of the four largest firms and individual audit engagements are spread throughout the year. Accordingly, the inspection reports prepared as a result of the first round of inspection visits of the Big 4 firms had not all been finalised at the time of preparing this report. We intend to report privately on our inspections of the Big 4 firms at least annually. Our annual public report will cover work undertaken in the year to 31 March.

As this is our first public report, a significant part of it is devoted to explaining our monitoring approach and the underlying objectives. We believe that interested parties will find it helpful to understand our monitoring approach and the overall objectives which guide it.

### **2.2 Coverage**

The AIU is taking over responsibility for the monitoring of the audits of all listed and other major public interest entities on a phased basis. The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work, the largest of which is the Quality Assurance Directorate of the ICAEW, will retain responsibility under the new arrangements for the monitoring of audit work outside our remit (i.e. the audits of entities which do not have any listed securities and those in whose financial condition there is not otherwise considered to be a major public interest). We wish to acknowledge the co-operation we have received from these monitoring units, in particular the ICAEW's Quality Assurance Directorate, in ensuring a smooth transition to the new arrangements.

In the period to 31 March 2005, we focused exclusively on the Big 4 firms and the audits of larger listed companies, those included in the FTSE 100 and 250 indices (collectively referred to as the FTSE 350), undertaken by them. We had completed, or substantially completed, reviews of 27 such audits as at 31 March 2005.

The large majority (some 83%) of listed<sup>1</sup> company audits in the UK, and virtually all the FTSE 350 audits, are undertaken by the Big 4 firms. The position in relation to audits of other major public interest entities is broadly similar with the Big 4 firms undertaking some 85% of those audits. We will extend coverage to the audits of all listed and other major public interest entities, and all firms undertaking this work, over the next two years. In the year to 31 March 2006 we plan to carry out second inspections of the Big 4 firms, including coverage of audits outside the FTSE 350, and initial inspections of selected firms outside the Big 4. The allocation of our resources is designed to reflect the relative levels of public interest involved, both in relation to the different types of audited entities within our scope and the different sizes of audit firms undertaking this work.

### **2.3 Focus**

The focus of our work is the quality of auditing. We do not focus solely on compliance with the requirements of the existing UK regulatory framework (although we recognise that audit quality is closely linked to this). By monitoring and promoting improvements in audit quality, we contribute to the FRC's overall aim of promoting confidence in UK corporate reporting and governance. We prioritise the recommendations to firms arising from our work on the basis of our assessment of their actual or potential impact on audit quality. Should our work identify areas in which changes to auditing, ethical or quality control standards appear to be needed to promote audit quality, we bring this to the attention of the FRC's Auditing Practices Board (which has responsibility for setting UK standards for auditors in these areas).

An important aspect of our work is assessing the appropriateness of the key audit judgments exercised in forming the audit opinion and challenging those judgments where appropriate. The appropriateness of the key audit judgments is central to the quality of an individual audit engagement. We therefore regard critical assessment of those judgments as an essential part of an effective audit quality inspection.

This report focuses on recommendations for improvement. This does not take away from the firms the high standards they demonstrate elsewhere in their audit work, which are not referred to in this report.

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<sup>1</sup> Listed in this context refers to companies, any of whose securities have been admitted to the official list (within the meaning of part 6 of the Financial Services and Markets Act 2000).

## **2.4 The Challenge for Firms**

Partners of the audit firms do not normally face external questioning on their audit judgments; this and the comprehensive and detailed nature of our monitoring have presented challenges to the firms, which we do not underestimate. The test for the audit firms will be the extent to which they embrace and value recommendations arising from the monitoring process.

The largest firms have now had the opportunity to adjust to the new regulatory regime and we will monitor the actions taken by them to implement our recommendations.

We note that all the major firms have been assuring investors, regulators and the UK Government of their commitment to promote audit quality and enhance public confidence in audited financial statements. Our work, focused as it is on audit quality, provides independent monitoring of those commitments. A commitment to audit quality necessarily involves a willingness to accept and implement recommendations designed to enhance it. We trust that all the firms will rise to the challenges which our work presents to them.

## **Three - Background**

### **3.1 Review of Regulatory Regime**

Following Enron and other well-publicised corporate reporting failures, the UK Government undertook a review of the regulatory regime for auditors and accountants in the UK. The report; 'Review of the Regulatory Regime of the Accountancy Profession' was issued in January 2003 and is referred to as the 'Swift' report. That report recommended enhancing the monitoring of the audits of listed and other major public interest entities through a new independent inspection unit (the AIU) reporting to a professional oversight board (the POBA) within an integrated independent regulator (the FRC). Under the new arrangements the professional accountancy bodies continue to register firms to conduct audit work, with their regulatory activities being overseen by the POBA. The audit registration committees of the accountancy bodies receive formal reports from the AIU on our monitoring work, with the POBA overseeing the action taken by them in response to our recommendations. The Companies (Audit, Investigations and Community Enterprises) Act 2004 implements the statutory changes necessary to give effect to these new regulatory arrangements.

### **3.2 Remit of the Independent Inspection Arrangements**

The scope of the AIU's inspections is the audit of all entities with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a major public interest.

The POBA is responsible for approving the AIU's work programme and, in particular, determining which audited entities fall within the "major public interest" category and therefore within the scope of our work. A description of such entities, as approved by the POBA, is set out in Appendix A. The monitoring units of the professional bodies remain responsible for the monitoring of other audits within the scope of audit regulation in the UK (i.e. those which are not within the scope of independent inspection by the AIU).

This approach is designed to ensure that independent inspection is focused on those audited entities and audit firms in respect of which the level of public interest is highest. Our analysis indicates that there are currently only five firms outside the Big 4 which audit a significant number of entities within our scope ("the Mid 5").

For firms below the Mid 5, therefore, we intend to focus our inspections on reviews of the small number of listed or other major public interest entities audited by them and to rely, where appropriate, on firmwide reviews undertaken by the monitoring unit of the body with which the firm is registered.

### 3.3 New Monitoring Approach

The AIU's monitoring approach is designed to provide a more challenging regime for the major firms than under the previous arrangements, in line with the recommendations of the regulatory review. The Swift report stated that:

"Current monitoring practice focuses primarily on processes and systems. Inspections and reports focus on ensuring that firms have robust audit processes and systems in place, rather than assessing the judgments made by auditors. We believe that an independent inspection unit would be able to make a real contribution by taking monitoring into new areas and in particular by focusing on the judgments taken by audit partners. A change to a more challenging, judgments-based approach could be more effectively driven by an authoritative regulator operating independently of the profession."

Consequently the AIU has developed and implemented an approach to audit monitoring for the major firms based on the following characteristics:

- Focus on the quality of auditing, with our recommendations to firms prioritised on this basis;
- Thorough, robust and challenging approach to inspection visits;
- Wide-ranging reviews of firmwide procedures, including an assessment of how the culture within firms impacts on audit quality;
- Selection of major audits for review which is largely risk-based;
- In-depth reviews of major audits, focusing on the quality of the group audit, including critical assessment of the key audit judgments made and a detailed review of compliance with UK Auditing Standards; and
- Review of the quality of reporting to the Audit Committee.

## Four - Scope of Audit Quality Inspections

### 4.1 The Concept of Audit Quality

The overall purpose of our work is to monitor and promote improvements in audit quality, thereby enhancing investor confidence in the audit process and financial reporting. Our responsibility extends beyond compliance with specific requirements of the regulatory framework and includes an assessment of the key audit judgments made.

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

- The Auditors' Code issued by the APB;
- The UK Audit Regulations and Guidance;
- UK Auditing Standards and other APB pronouncements; and
- Ethical guidance issued by the relevant professional body.

The APB's Ethical Standards for auditors apply to audits of financial statements for periods starting on or after 15 December 2004. We therefore also had regard to areas in which changes will need to be made by the firms to comply with these Standards.

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

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

These elements of audit quality may be summarised as follows:

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

## 4.2 Assessing Audit Quality

Audit quality inspections involve assessing the independence of the auditors, the sufficiency and appropriateness of the audit evidence obtained and the appropriateness of the key audit judgments made. In some cases it may be possible to determine in this way that an inappropriate audit opinion was issued. It is not, however, usually possible to confirm the appropriateness of the audit opinion without re-performing some or all of the audit work. We review only information held by the auditors, do not have access to their clients' records or personnel and do not re-perform audit work undertaken by them.

Audit inspections therefore necessarily involve an assessment of the key factors driving audit quality which are *inputs* to the audit process. Using the terminology adopted in the 'International Standard on Quality Control (UK and Ireland) 1' for factors driving audit quality, the key inputs to the audit process which we assess during our inspections may be summarised as follows:

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

### **4.3 Reviews of firmwide procedures**

Our reviews of firmwide procedures address all aspects of firms' systems of quality control, including the internal quality reviews which they are required to carry out at least annually. Our review procedures recognise the importance of the culture established by the firm's leadership team in promoting audit quality and professional integrity (the "tone at the top"). We consider, for example, how the firm's commitment to quality and integrity is reflected in the basis on which partners are appointed, remunerated and promoted to more senior roles.

Our review of firmwide procedures was primarily carried out in 2004 and was based on the regulatory framework relevant to that period. The APB's Ethical Standards first applied to audits for periods starting on or after 15 December 2004 and therefore did not apply during the period of our review. We have nevertheless had regard to the areas in which changes will need to be made by the firms to comply with those Standards.

Our procedures include requesting firms to set out in writing how their audit methodology meets all the requirements of UK Auditing Standards and reviewing their responses against those standards and their methodology.

The basis on which audit partners are appointed to lead major audits or act as the independent review partner, and the procedures for rotating them off major audits to avoid unacceptable familiarity threats arising, is another important focus of our work. The roles of the lead partner and independent partner are key to ensuring the quality of an individual assignment. We review how the firm ensures that those appointed to these roles are independent of the audit client and possess the necessary competencies and commitment to discharge properly the responsibilities involved.

The regulatory framework requires that firms have in place an annual compliance review which includes reviews of a selection of completed audits. This process is known by different names at different firms, but we have referred to it as the Audit Quality Review (AQR). The number of audits reviewed in an AQR far exceeds those subject to external monitoring. We review how the firm conducts their AQR, how effective the process is, the overall findings (comparing these with our own findings) and any remedial actions taken or planned by the firm.

### **4.4 Reviews of Individual Audit Engagements**

Our reviews of individual audit engagements form a key element of our monitoring approach. For large (FTSE 350) listed companies, which were the focus of our reviews in this first year, we made our selection primarily on a risk basis.

Our file reviews were carried out during 2004 and early 2005 and covered audits for accounting periods with year ends ranging from 30th September 2003 to 31st December 2004. Those reviews were based on the regulatory framework in place at the time, principally the UK Auditing Standards issued by the APB.

We carry out in depth reviews giving us a sound basis on which to assess the quality of the audit reviewed. We use work programmes designed to ensure that compliance with all relevant requirements of UK Auditing Standards is assessed as part of our review.

Our inspection teams challenge audit partners, where appropriate, regarding the basis on which key audit judgments were made. We believe that challenging audit judgments in this way is a key feature of an effective audit quality review.

## **4.5 Reporting**

We prepare detailed reports on each audit engagement we review and these are copied to senior management within the firm's audit practice. The key issues arising across our reviews of individual audit engagements, and those arising from our review of firmwide procedures, are set out in our formal private report to the firm and the audit registration committee of the accountancy body with whom the firm is registered (the ICAEW in the case of the Big 4 audit firms).

Our private reports include prioritised recommendations to the firms concerned together with responses and an action plan from the firms. We prioritise the issues and our recommendations to the firms on the basis of our assessment of their actual or potential impact on audit quality (as opposed to solely on the basis of their implications for the firm's compliance with the existing regulatory framework).

During 2005/6 we will carry out further inspection visits to each of the Big 4 firms (and selected other firms as explained in Section 3.2 above). During those visits we will assess the progress made by the firms against the action plans agreed as well as carrying out reviews of a wider range of audits.

Current policy is not to publish any part of our reports on individual inspections<sup>2</sup>. A public report on the overall results of our inspections will, however, be published on an annual basis, as set out herein.

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

## **Five - Principal Issues and Themes Arising**

In this section we explain the principal themes and issues arising from our inspection visits to the Big 4 firms in the period to 31 March 2005. Not all these themes and issues apply to every firm and, where they do apply to more than one firm, there will inevitably be differences in degree. Where the theme or issue applies to all four firms we have stated this and, similarly, where an issue applies to only one firm we have made this clear. In other cases it should be assumed that the issue applies to some, but not all, firms or the degree to which it applies varies markedly across the firms.

### **5.1 Leadership ("Tone at the top") and human resources**

#### **5.1.1 Emphasis on audit quality**

The importance of promoting and enhancing audit quality has been a high profile issue in the UK recently. We found the firms' public commitments to audit quality to be reflected in the degree of attention the issue received in internal and external communications from their senior management. However, the strategies of the firms' audit practices placed different degrees of emphasis on the importance of achieving audit quality. The achievement of high quality audits needs to be clearly stated as the overriding objective of the audit practices of all the firms in meeting their commercial objectives. We have recommended in some cases that the firms recognise this more clearly in their strategies.

#### **5.1.2 Partner appraisals and objectives**

The documented goals and objectives established for partners, against which their performance is measured, focused mainly on commercial considerations, such as revenue growth and profitability. There was generally only limited visible focus on quality indicators. We have recommended, where appropriate, to the firms that they ensure quality indicators are an integral and visible part of their human resources system. We also found a lack of discipline in some firms in ensuring that the appraisal procedures established for partners, and other senior members of staff, were adhered to. We have recommended that these matters are addressed; including making any necessary changes to the appraisal process to ensure that it is viewed positively by partners.

#### **5.1.3 Partner promotions**

The basis on which candidates for promotion to audit partner level are assessed was generally found to focus primarily on leadership skills and the ability to generate new business. Quality considerations did not appear to feature prominently. We also noted that a formal system to address successful candidates' development needs was not always in place. We have recommended that improvements to some firms' procedures in these areas are implemented.

Whilst taking soundings from clients' Audit Committees as to the suitability of partner candidates would be an appropriate form of external reference, we found that one of the firms includes in its audit partner nomination process references obtained by candidates directly from their own audit clients. We believe that this could potentially compromise the independence of partner candidates in relation to those clients and is therefore inappropriate.

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

### **5.2.1 Partner Rotation**

The need to avoid, and be seen to avoid, threats to objectivity and independence arising through long association with the client has led to a tightening of ethical requirements regarding partner rotation (initially through the revised ICAEW Ethical Guidelines and now through the Ethical Standards issued by the APB). The acceleration of partner rotation requirements has created challenges for the firms.

Practices have existed in the past, and continue to a degree at some firms, whereby, on rotation, the outgoing audit engagement partner moves to a role such as 'relationship partner', 'advisory partner', 'lead partner' or similar role. Such partners, whilst not being categorised as members of the audit engagement team, would maintain relationships at the highest level with the client and may attend, or have the opportunity to attend, Audit Committee meetings. Given the seniority and experience of such partners and the depth of their contacts with clients, the perception, and perhaps the reality, was that those partners continued to exercise influence over the audit and important audit judgments.

To the extent that such practices continue to exist, the firms need to consider whether any safeguards that might be applied are sufficient to ensure compliance with the underlying principles of the ethical requirements and the need to maintain, and be seen to maintain, auditor independence.

Succession planning is potentially onerous and complex in relation to large clients operating on a global basis. It is particularly challenging where the client is a global leader operating in a specialist field. This can make it difficult, even for the Big 4 firms, to appoint partners with relevant industry experience to key roles who have not already had a long association with the audit client, such that their independence and objectivity is, or may appear to be, threatened.

To rise successfully to this challenge the audit firms need to maintain comprehensive systems and procedures to ensure that they can actively manage and closely monitor succession planning for their clients. Management of partner rotation needs to embrace fully the principles underlying the ethical standards, as well as the specific requirements under those standards, if a need to incorporate a greater level of prescription into the regulatory framework is to be avoided. The firms need to exercise care to avoid practices which push at the limits of these underlying principles.

Some of the issues we identified in this area are set out below. We will continue to pay particular attention to this area in our second (2005/6) visits to these firms.

### ***Long-Serving Partners***

In some cases audit engagement partners for listed clients had been partners on the same client group, but in different roles, for a considerable length of time. These cases related to periods when the ICAEW Ethical Guidelines applied and pre-dated the APB Ethical Standards. The firms concerned explained why they were satisfied that the cases did not breach any specific requirements and therefore complied with the ICAEW Ethical Guidelines, taking account, in some cases, of the transitional arrangements available within those guidelines.

At one audit firm the engagement partners for two FTSE 100 clients had fulfilled partner roles with the client group for 12 and 16 years respectively, and at one of these clients other partners had also been involved for more than seven years.

At another audit firm the engagement partner for a FTSE 100 client had served in that capacity for six years and overall had held positions within the audit team for 20 consecutive years, ten of which were as a partner. On a FTSE 250 company the engagement partner had acted in various partner capacities across the group for 15 years.

A continuous period of service at partner level on the same group for the length of time set out above carries with it a significant threat, whether actual or perceived, to objectivity and independence and should either be avoided or sufficient, clearly documented, safeguards put in place.

### ***Engagement Partners of significant subsidiaries and operating units***

The ICAEW Ethical Guidelines and the APB Ethical Standards both contain provisions to limit the period of involvement of 'key audit partners' ('key audit principals' in the case of the ICAEW Ethical Guidelines).

The APB Standards (previously the Guidelines) contain a relatively broad definition of the term 'key audit partner'. The audit firms have each developed policies and guidelines to determine which partners fall within the definition based on the circumstances of the particular audit arrangements. These policies differ between firms, particularly as regards the extent to which partners with responsibility for significant subsidiaries and divisions are classified as key audit partners and therefore subject to the relevant restriction on time served. We have recommended to some firms that they review their policies and procedures for identifying key audit principals due for rotation.

### ***Transitional provisions***

Both the ICAEW Ethical Guidelines and the APB Ethical Standards have certain transitional provisions in relation to the strengthened requirements for partner rotation. Those transitional provisions include an extension to the period for rotation of audit engagement partners in circumstances where a change would impair audit quality. Firms generally use, and intend to use, these transitional provisions in the limited circumstances intended. However, we noted that one firm's stated policy was that in most cases the threat to audit quality arising from hastily applied rotation will result in advantage being taken of the transitional relief.

#### **5.2.2 Client continuance and risk identification**

The firms all have procedures to assess the risks associated with their audit clients and to ensure that their annual continuance as clients is considered and approved at an appropriate level. The identification of risks in this way should lead to those risks being properly addressed during the audit, both in terms of the planned audit procedures and the resources allocated to the audit, such as additional and/or more experienced staff resources, consultation procedures and independent review. However, in practice we found that at some firms the link from the risks identified at the client acceptance stage through to the execution of the audit was insufficiently clear.

### **5.3 Engagement performance**

The comments made in relation to our findings from reviews of individual audit engagements are based on the 27 reviews completed (or substantially completed) as at 31 March 2005. Those audit engagements, primarily selected on a risk basis, were amongst the largest audit clients of the firms.

#### **5.3.1 Challenging audit judgments**

A key part of our approach is to review the judgments involved in the audit. These include the judgments made in relation to financial reporting issues and accounting estimates. In addition, we have reviewed the following areas, all of which require the use of audit judgment, which we have commented on separately below:

- The extent of audit evidence required and timing of audit procedures (see 5.3.5)
- The extent of direction given to and reliance on the work of network and non-network firms auditing subsidiaries (see 5.3.7)
- The reporting of issues to Audit Committees (see 5.3.8)

The following financial reporting issues, in respect of which audit judgments were made, are examples of the areas we challenged as part of our file reviews:

- Revenue recognition
- Disclosures in group accounts
- Categorisation and appropriateness of provisioning levels
- Carrying value of assets

The basis on which revenue for part of the client's business was recognised as a principal when other parts of the business recognised revenue as an agent.

On a group with major US interests, the auditor's acceptance of the different basis of recognition of deferred tax asset balances between the UK and the US.

The accounting treatment adopted by another client in relation to operating lease incentives.

Our reviews of the key audit judgments made in relation to financial reporting issues and accounting estimates on individual audit engagements indicated that they appeared, in the great majority of cases, to be both appropriate and soundly based. However, as a result of insufficient documentation in many cases, it was often necessary to form a view as to the appropriateness of such judgments on the basis of oral explanations provided to us. In two cases we believed there was sufficient doubt as to whether the accounting treatment adopted, balance sheet presentation and/or disclosures provided complied with UK GAAP. We therefore referred these cases to the FRC's Financial Reporting Review Panel (the issues concerned did not affect reported profits in either case).

### **5.3.2 Compliance with Auditing Standards**

The audits we reviewed complied with most requirements of UK Auditing Standards. However, there were areas of non-compliance with certain aspects of some Auditing Standards. There were also documentation issues regarding the procedures carried out to comply with Auditing Standards. The key issues identified with regard to the application of Auditing Standards were as follows:

- Quality control - review procedures and Independent Review Partner involvement (see 5.3.3 and 5.3.4)
- Audit evidence and analytical procedures (see 5.3.5)
- Audit documentation (see 5.3.6)
- Reliance on the work of subsidiary auditors (see 5.3.7)
- Reporting to Audit Committees (see 5.3.8)

Examples of recurring issues where there was a lack of evidence of compliance with certain aspects of some Auditing Standards also include the following:

- Laws and regulations - insufficient identification of the relevant laws and regulations affecting the client's business and/or procedures to identify possible or actual non-compliance therewith
- Going concern - insufficient consideration of client management's own procedures in ensuring it was satisfied with the going concern assumption and that this covered a period of at least 12 months after the date of the approval of the accounts
- Subsequent events - too long a gap between the procedures undertaken to identify subsequent events and the approval of the accounts

The areas of non compliance appear to be due to either unclear or insufficient guidance within the audit methodology of the firm, limited knowledge of auditing standards by the staff concerned or insufficient review procedures. We comment on the first two matters below and on review procedures in the following section.

### ***Guidance within the audit methodology***

We identified some areas in which certain requirements of UK Auditing Standards were not reflected in individual firms' audit methodologies and recommended that these deficiencies be rectified. We also noted that certain guidance in some firms' audit methodologies was presented in a less user-friendly way than in other firms and that this appeared to contribute to failures by audit staff to comply fully with it.

### ***Knowledge of Auditing Standards***

We noted that knowledge of the requirements of certain Auditing Standards amongst audit teams appeared weak in some cases. This reflects, to some extent, the focus within the firms on their own audit methodologies. However, a lack of awareness of the requirements of UK Standards on the part of audit staff increases the likelihood of unclear or inadequate guidance on certain areas in the firm's audit methodology resulting directly in non-compliance with the relevant requirements.

The adoption of International Standards on Auditing in the UK, subject to certain UK add-ons, for December 2005 year-ends provides an opportunity for firms to raise awareness of the requirements of

Auditing Standards when training staff on resulting changes to their audit methodology. It also provides an opportunity for firms to assess whether their audit methodology can be made more user-friendly in certain respects (such as providing an easily accessible link to Auditing Standards and guidance).

### **5.3.3 Quality control - review procedures**

The review of audit files is a critical part of the quality control procedures. The timing of these review procedures is important, as they need to be carried out in sufficient time to ensure that the partner and manager can adequately consider the key issues prior to reporting them to the Audit Committee and signing the audit report. In addition, there needs to be sufficient time to clear the review points. It is also important, for listed company audits, to have an adequate level of technical input to the review of the client's financial statements and adequate independent partner involvement.

We have identified the following issues in relation to review procedures:

- Evidence and timing of file reviews
- Review of certain procedures required by Auditing Standards
- Extent of technical review of financial statements
- Involvement of the independent partner

These issues are commented on below, except for independent partner involvement which we comment on in the next section (5.3.4).

#### ***Evidence and timing of file reviews***

We found that the review of the audit by the partner, and the detailed file reviews by managers and other members of staff, were insufficiently evidenced in a number of cases at some firms. We also found at some firms that the sign offs to evidence completion and clearance of review points were sometimes dated after the date the audit report was signed. Some electronic audit systems do not permit finalisation and archiving unless all areas are electronically "signed", even though the substantive work has been completed much earlier. It is therefore difficult subsequently to ascertain when the review was undertaken and all the issues cleared.

#### ***Review of procedures required by Auditing Standards***

Audit partners usually, and understandably, focus their own reviews on critical audit issues. Reviews of certain audit procedures required by Auditing Standards, and under the firm's own methodology, are therefore typically carried out by either the audit manager or other staff. We identified a number of issues in relation to the application of certain Auditing Standards which, taken together, indicate that

the firms' own review processes in these areas could operate more effectively. Individuals to whom responsibility has been delegated for reviewing compliance with the firm's methodology in certain areas need to ensure that all relevant procedures required to be carried out have been duly performed and documented.

### ***Extent of technical review of financial statements***

All the firms require, as part of their quality control procedures, a technical review of the financial statements of larger listed companies to be carried out. However, not all the firms require this to be carried out within their technical department or by dedicated full-time specialists. One firm uses a pool of non-dedicated audit managers, outside the technical department, to carry out this review. We believe that increased involvement in the review of listed companies' financial statements by the firms' central technical departments would be beneficial in ensuring that listed companies' accounting policies and disclosures comply with the relevant financial reporting framework.

Appropriate input from technical specialists is likely to be particularly important in view of the adoption of International Financial Reporting Standards by listed companies in 2005 (at least in their consolidated accounts). Where this is not already the case, therefore, we believe that the coverage of such technical reviews should be extended to all listed and other higher risk entities and that the firms should consider whether more input from technical specialists is needed.

### **5.3.4 Quality control - Input of Independent Review Partner (IRP)**

#### ***Involvement of IRP***

Auditing Standards require that an IRP is appointed for all listed company audits. The role of an IRP is to provide an independent assessment of the quality of the audit, including the key decisions and significant judgments made. IRPs have no contact with the client and are therefore able to discharge their responsibilities without the same pressures faced by engagement partners. Their role, when properly undertaken, is a key control and safeguard within firms in ensuring the quality of listed company audits.

The Auditing Standard on quality control indicates that, to undertake the role properly, an IRP would be expected to consider the rigour of the planning process, risks identified, the planned responses to those risks, the results of the audit work, the appropriateness of judgments made, the significance of potential changes to the financial statements, the appropriateness of reporting and the objectivity of the audit team and independence of the firm.

All firms have procedures to ensure that IRPs are in place on all listed company audits. On the files we reviewed, however, there was often insufficient evidence of meaningful and timely involvement in the audit by the IRP. At all the firms we found that the time recorded by the IRPs was frequently less than one day over the course of a year which in our view is insufficient to enable them to fulfil their role effectively. The firms believe that, as the IRP role may often involve spending small amounts of time on a frequent basis, the time spent is often not fully recorded by the partners concerned.

The firms should communicate clearly to IRPs the requirements of that role, the need to allocate sufficient time to fulfil it properly and the need to record properly their involvement in the audit. The firms should monitor the time spent by IRPs and follow-up cases where insufficient time appears to be being allocated to this role to ensure that this important internal control is effective.

We intend meeting with selected partners who are IRPs during our 2005/6 inspections, separately from audit engagement partners, to discuss the manner in which they discharged their IRP responsibilities over a range of clients and their involvement in challenging judgments exercised by the engagement team on significant audit issues.

### ***Rotation of IRPs***

The importance of the IRP's role means that the same independence and objectivity considerations should apply as for the audit engagement partners of listed company clients. Accordingly, the APB's Ethical Standards require that firms implement policies and procedures to rotate IRPs on the same basis as listed company audit engagement partners. We have recommended to one firm that their databases be expanded to include IRPs as soon as practicable.

### **5.3.5 Audit evidence - extent and timing of procedures**

Our file reviews were based on the review of group audit working papers and certain UK based subsidiaries of those groups. The firms stated that, as a result of the frameworks within which their firms operate, it was not possible to grant us access to the working papers of overseas network firms responsible for the audit of subsidiaries. Consequently we were not able to see the full extent of audit evidence supporting significant financial statement assertions in the group financial statements.

Insufficient audit evidence can arise if too much reliance is placed on controls, with ineffective testing, or on analytical procedures which are not sufficiently detailed. The timing of audit procedures is critical when the auditors are planning to rely on controls. The testing of controls must be carried out at a sufficiently early stage to ensure that adequate consideration can be given to the extent of required substantive testing. Recommendations in relation to the extent and timing of procedures have been made to some firms as a result of issues identified on a limited number of the audits we reviewed.

### 5.3.6 Audit documentation

We identified a need to improve the quality of audit documentation across all firms, in respect of many of the audit engagements we reviewed. This was also an issue that the firms themselves had recognised as needing to be addressed following previous internal and external reviews. In many cases we found that audit work undertaken could not be fully understood without obtaining oral explanations from the audit team and that the rationale for key audit judgments was not adequately recorded on the audit files. It was apparent that actions previously taken to improve the position (such as issuing reminders to audit staff of the need to document properly all work undertaken) had not been effective.

Senior management within the audit firms must emphasise that poor audit documentation is unacceptable. This message needs to be reinforced by the importance that those responsible within firms for reviewing audit working papers attach to proper documentation of audit work undertaken and audit judgments exercised. We are aware that the Auditing Standard covering documentation requirements is currently under review (an exposure draft of a revised Standard was issued for comment last year). However, firms should not await the issue of the revised Standard before taking effective action to improve documentation standards in response to the findings of both internal and external quality reviews.

Factors identified which may be contributing to the persistence of this problem include:

- A failure to include certain important documentation, on which reliance has been placed, on the audit files so that it is necessary to collate information from other sources within the firm to demonstrate that appropriate audit work was undertaken.
- The use of the word "done" against general descriptions of audit procedures.
- Insufficient tailoring of generic audit procedures to the circumstances of the client.
- Audit programming software that does not require a sign off against each planned audit procedure but only against the planned procedures as a whole. As a result, reviewers cannot easily see if all planned steps have in fact been completed.
- An apparent failure by partners and managers to focus sufficiently on adequate documentation of audit work when reviewing work undertaken by others (as well as establishing whether or not appropriate audit work was in fact undertaken).
- A failure to place sufficient emphasis on the importance of audit documentation in categorising the results of file reviews undertaken as part of firms' AQRs. In particular, the grading criteria in use do not always prevent audits, in respect of which the standard of documentation is poor, nevertheless receiving an overall 'Satisfactory' grading.

At one firm the use of an electronic database of audit procedures led to the inclusion of planned procedures in the audit programme without sufficient tailoring or consideration of their appropriateness. Consequently some of the audit procedures were not in fact undertaken, additional audit procedures were undertaken, often in different areas of the file, and the audit work was insufficiently cross-referenced to the planned procedures. As a result the audit work relied upon by the team was different from that documented and filed in the relevant electronic file section.

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

During our inspection visits in 2004/5, we have accepted oral explanations of work undertaken, where we considered this to be appropriate, and not taken the view that work which was not documented is deemed not to have been carried out. Instead the lack of adequately documented audit procedures has been raised either under the general heading of audit documentation or as non-compliance with specific Auditing Standards (as regards the documentation needed to demonstrate compliance with those Standards). We note that the exposure draft of the revised Auditing Standard on documentation includes clear guidance to the effect that, while oral explanations by the auditor may be used to clarify information contained in the audit documentation, they do not on their own represent adequate support for the audit work performed or the conclusions reached.

The onus is on the firms, and their audit partners and staff, to address this issue and avoid a need for ever more prescriptive standards and regulations.

### **5.3.7 Reliance on the work of subsidiary auditors**

Auditing Standards contain only limited guidance on group audits (although an exposure draft of a comprehensive group audits standard was recently issued for comment). The firms have, to varying degrees, produced their own internal guidance and audit teams have needed to apply judgment in deciding the appropriate extent of, and basis for, reliance placed on other auditors' work.

The level of guidance produced by firms in relation to group audits varies considerably. Some firms produce pro-forma group audit instructions. Other firms do not have such detailed guidance and rely more on the judgments of individual audit teams. In some firms, where little guidance on this area exists, we challenged the audit teams in relation to the direction given to their overseas network firms and the extent of reliance on their work, especially in relation to:

- Guidance given to audit teams in relation to the differences between UK and international accounting and auditing standards
- Guidance given on the approach to critical audit matters
- Why audit clearance signed off in accordance with local auditing standards was accepted when clearance under UK Auditing Standards had been requested
- The extent of visits to overseas locations and the attendance at year end audit meetings

Good practice in this area was typified by the following example:

#### **Good practice example**

- The firm had prepared detailed guidance and pro-forma group instructions to assist group audit teams
- The audit team gave detailed instructions on the approach to critical audit areas and on the differences between UK and global audit methodologies to subsidiary auditors
- The audit engagement partner visited all key overseas subsidiaries, documented the visits, and considered industry expertise and local UK GAAP knowledge
- Procedures were adopted to identify issues before the year end regarding overseas subsidiaries and those issues were followed up by subsidiary auditors after the year end

The firms necessarily rely heavily on work carried out in other countries by firms in their own international network. In doing so, they take into account the use by these firms of global methodologies and procedures. In our view, greater use could be made of the results of quality control reviews in other countries in identifying any issues that could affect the level of risk associated with relying on the work of network firms in particular jurisdictions.

#### **5.3.8 Reporting to Audit Committees**

The quality of reporting to Audit Committees was of a high standard on many of the audits reviewed. However, we identified the following issues in relation to certain audits:

- In some cases key accounting policies or critical matters affecting the accounts had not been discussed in sufficient detail with the Audit Committee.

- In some cases the finalisation of a number of significant matters was not incorporated into the report to the Audit Committee, as the last Audit Committee meeting was held some weeks prior to approval of the group accounts.
- In some cases not all unadjusted audit differences were notified to the Audit Committee.
- In one case no written report was prepared by the auditors of their findings arising from the audit. Instead a report was prepared by the company's management, which we understand was agreed by the auditors.

In our view a key element of audit quality is that an appropriate and balanced written report should be provided to the Audit Committee. Best practice would suggest such a report be prepared by the auditors independently of management, but where management prepares such a report we would expect the auditors to confirm in writing that in their opinion it is balanced and complete.

## **5.4 Monitoring**

All the firms have Annual Quality Review procedures or AQRs. The firms' review procedures tend to focus mainly on completed audit assignments, however, with reviews of the adequacy and operation of their quality control systems generally being limited. We have recommended, where appropriate, that the firms consider expanding the scope of their internal reviews. The effectiveness of a firm's compliance function should, in our view, itself be subject to regular review in line with best practice in other regulated sectors.

The main concerns we identified in this area were in relation to:

- Limitations placed on the scope of our work by some of the firms.
- The coverage of compliance with the requirements of Auditing Standards.
- The extent to which grading systems in use sufficiently distinguish between the quality of individual audits.

### **5.4.1 Scope limitations**

All firms gave us access to their final reports on their AQRs for 2004. However, not all firms gave us access to the detailed reports on the individual audits reviewed or allowed attendance at AQR closing meetings.

While we understand that the level of access provided by individual firms was in line with their practice in previous years, we do not consider it acceptable for any firm to seek to limit the scope of our work in this way. Accordingly, we will expect full access to be provided by all firms in future.

#### **5.4.2 Coverage of compliance with Auditing Standards**

All audit reports are required to confirm compliance with Auditing Standards in the conduct of the audit. All firms seek to achieve compliance by ensuring that their own audit methodology, which audit teams are expected to comply with, meets all the requirements of the Auditing Standards. Audit firms do not utilise checklists or other procedures during audit fieldwork to ensure directly that all Auditing Standards have been complied with. Any checklists etc. used are instead designed to ensure that their own methodology has been followed. Similarly, the firms' AQR processes include a review of the quality of the audit work undertaken and compliance with the firm's own methodology on a sample of completed audits, rather than directly reviewing compliance with Auditing Standards. We have recommended that the firms review whether their AQR is sufficiently focused on compliance with the requirements of Auditing Standards, as reflected in their own audit methodology, and the extent to which the questionnaires and guidance used by firms' reviewers properly address these requirements.

Where deficiencies are identified by the AQR process, these are typically categorised as either documentation issues or non-compliance with the firm's own methodology. Our reviews indicate, however, that these deficiencies often constitute non-compliance with the requirements of Auditing Standards (and therefore that the statement of compliance made in the relevant audit reports was incorrect), even though they have not been categorised as such by the firm. We have recommended that AQR findings which constitute non-compliance with Auditing Standards, and not solely a deficiency in documentation or non-compliance with the firm's own procedures, should be clearly reported as such. If the AQR findings indicate that the assurance provided in an audit report of compliance with Auditing Standards was not soundly based, and that required audit procedures were not in fact carried out, this needs to be recognised and consideration given as to whether, and if so what, further action is necessary in the circumstances.

#### **5.4.3 Grading of individual audits**

The firms use different grading criteria for individual audit engagements reviewed in their AQRs. We noted that these criteria did not always sufficiently distinguish between the quality of the individual audits reviewed, with significant variations in the distribution of gradings. In some cases audits reviewed were graded as satisfactory, even though a number of significant deficiencies had apparently been identified, either with regard to the documentation necessary to demonstrate compliance with standards or other matters.

The firms should view the AQR as a key tool for measuring, promoting and enhancing audit quality. The distribution of grades for the individual audits reviewed should enable firms to identify and reward partners achieving high quality audits and, equally, penalise partners responsible for audits falling below the standard expected by the firm. Firms should not adopt grading systems which provide little incentive to improve the quality of the audits. We have recommended to some firms that they review the grading criteria used by them, with this objective in mind.

## APPENDIX A

### Scope of Independent Inspection 2005/06

Audits of the following entities are within the scope of the work of the Audit Inspection Unit (AIU) of the Professional Oversight Board for Accountancy. The AIU will review a sample of relevant audit engagements at each firm selected for an inspection visit. In 2005/6 the AIU will focus their inspection visits on the Big 4 firms plus those firms auditing the largest number of entities within the agreed scope of the AIU. The AIU will normally review the last completed audit of an entity. In 2005/6, the relevant financial year is likely to have ended in either 2004 or 2005.

- All entities with listed securities (equity and debt). *(Note 1)*
- AIM or Ofex companies with a market capitalisation in excess of £100million. *(Note 2)*
- Unquoted companies or groups of companies in the UK which have either:
  - a) Group turnover in excess of £500million; or
  - b) Group long-term liabilities in excess of £250million and turnover in excess of £100million. *(Notes 3 and 4)*
- Unquoted companies or groups which are subsidiaries of foreign parent companies where the turnover of the UK group or company is in excess of £1billion. *(Notes 3 and 5)*
- Private sector pension schemes with either more than £1billion of assets or more than 20,000 members. *(Note 3)*
- Charities with income exceeding £100million. *(Note 3)*
- Friendly Societies with total net assets in excess of £1billion. *(Note 3)*
- Building Societies with assets exceeding £1billion. *(Note 3)*
- Open-Ended Investment Companies and Unit Trusts managed by a fund manager with more than £1billion of UK funds under management. *(Notes 2 and 6)*
- Lloyd's Syndicates with an underwriting capacity in excess of £250million. *(Notes 3 and 6)*
- Mutual Life Offices whose "With-Profits" fund exceeds £1billion. *(Notes 3 and 6)*

## **Notes**

*Note 1: This refers to companies any of whose securities have been admitted to the official list (within the meaning of part 6 of the Financial Services and Markets Act 2000), not to AIM or Ofex (see below) and not to overseas markets, as at either the previous 31 March (i.e. 31 March 2005 for 2005-6) or, if later, the date of the last published set of accounts.*

*Note 2: These measures will be applied as at the previous 31 March, i.e. 31 March 2005 for 2005-6.*

*Note 3: These measures will apply as at the date of the last published set of accounts.*

*Note 4: This category is intended to include companies or groups of companies that are privately owned, whether directly or through another investment vehicle, trust or overseas holding company. It is also intended to include those companies owned by private equity funds or other institutions. It is not intended to include subsidiaries of any other category in this list.*

*Note 5: This category is intended to cover major subsidiaries of overseas groups. If there are a number of separate subsidiaries trading in the UK and group consolidated accounts are not produced, this measure will be applied on an individual company basis.*

*Note 6: Open-Ended Investment Companies, Unit Trusts, Lloyd's Syndicates and Mutual Life Offices (which are not constituted as companies or friendly societies) were not previously within the scope of the Audit Regulations issued by the ICAEW, ICAS and ICAI. These Regulations will shortly be amended to bring these entities within scope.*





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