



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2011/12 INSPECTION OF DELOITTE LLP

15 JUNE 2012

This report is issued by the FRC's Audit Inspection Unit. It has been approved for publication on behalf of the Professional Oversight Board.

Contents		Page
1	Background information and key messages	2
<hr/>		
2	Principal findings	6
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Appendix A	Objectives, scope and basis of reporting	14
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Appendix B	Firm's response	17

1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the inspection of Deloitte LLP (“Deloitte” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2012 (“the 2011/12 inspection”). Our inspection was conducted in the period from April 2011 to January 2012 (referred to as “the time of our inspection”). The objectives of our work are set out in Appendix A.

Our inspection comprised reviews of individual audit engagements and a review of the firm’s policies and procedures supporting audit quality.

We reviewed 14 audit engagements undertaken by the firm in our 2011/12 inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between August 2010 and March 2011. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit.

Each year we select a number of areas of particular focus. For 2011/12, these were: group audit considerations; the valuation of assets held at fair value; the impairment of assets (including goodwill and other intangibles); the assessment of going concern; revenue recognition; related parties and the quality of reporting to Audit Committees.

In addition, we undertook one follow-up review to assess the extent to which our prior year findings on that audit had been addressed in the following year’s audit.

Our review of the firm’s policies and procedures supporting audit quality covered the following areas:

- Tone at the top and internal communications
- Transparency report
- Independence and ethics
- Performance evaluation and other human resource matters
- Audit methodology, training and guidance
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Other firm-wide matters

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

Further information on the scope of our work and the basis on which we report is set out in Appendix A.

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

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

The AIU acknowledges the co-operation and assistance received from the partners and staff of Deloitte in the conduct of the 2011/12 inspection.

1.2 Background information on the firm

Deloitte is a UK limited liability partnership and is the UK member firm of Deloitte Touche Tohmatsu Limited. The firm operates from 25 offices in the UK through four service lines, being Audit, Tax, Consulting and Corporate Finance. All statutory audit work is conducted through the Audit service line which comprises eleven groups, based on geography and industry sectors.

For the year ended 31 May 2011, the firm's turnover was £2,098 million, of which £652 million related to the Audit service line. There was a total of 706 partners, of whom 182 were authorised to sign audit reports, and 31 employees who were authorised to sign audit reports.¹

The AIU estimates that the firm audited 334 UK entities within the scope of independent inspection by the AIU as at 28 February 2011. Of these entities, AIU records show that

¹ As disclosed in the annual return to the ICAEW as at October 2011.

161 had securities listed on the main market of the London Stock Exchange, including 19 FTSE 100 companies and 62 FTSE 250 companies.

Audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area are subject to inspection by the AIU under separate arrangements agreed with the relevant regulatory bodies and the principal findings of any such reviews undertaken in the year are included in this report. Our records show that the firm has 31 such audits, including four FTSE 100 companies and two FTSE 250 companies.

1.3 Overview

We focus in this report on matters where we believe improvements are required to safeguard and enhance audit quality. We set out our key messages to the firm in this regard in Section 1.4. While this report is not intended to provide a balanced scorecard, we highlight certain matters which we believe contribute to audit quality, including the actions taken by the firm to address findings arising from our prior year inspection.

The firm places considerable emphasis on its overall systems of quality control and has appropriate policies and procedures in place for its size and the nature of its client base in most areas which are subject to our review. Nevertheless, we identified certain areas where improvements are required to those procedures, which are set out in this report.

Our file review findings, as set out in Section 2, largely relate to the application of the firm's procedures by audit partners and staff, whose work and judgments ultimately determine the quality of individual audits.

1.4 Key messages

The firm should pay particular attention to the following areas in order to enhance audit quality:

- Ensure group audit teams are adequately involved in discussions with component audit teams and that there is evidence of those discussions and the review of the component auditors' work.
- Provide further guidance and training to audit teams regarding the assessment of the impairment of goodwill and other assets, especially in relation to key assumptions and disclosures, including the relevant financial reporting requirements.

- Ensure audit teams pay more attention to planning and performing the audit of revenue, with appropriate focus on identifying and responding to significant risks.
- Provide further guidance on the use of sampling for substantive testing purposes, particularly in relation to judgmental sampling.
- Ensure audit quality is considered in the performance evaluation of audit staff and that there is a direct impact on partner remuneration resulting from quality review findings.
- Ensure that the firm's annual review of the quality of its audits is more focused on monitoring areas where there have been recurring inspection findings on audits.

2 Principal findings

The comments below are based on our review of individual audits and the firm's policies and procedures supporting audit quality.

2.1 Review of audit engagements

Follow-up of audits reviewed in the prior year

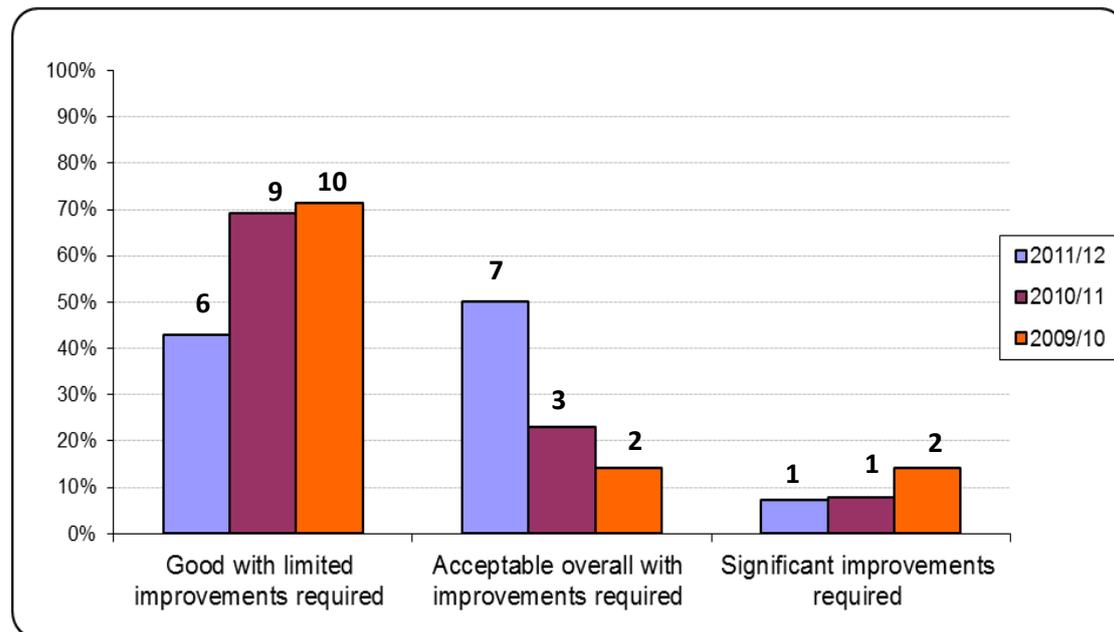
We undertook a follow-up review of one audit we reviewed in the prior year, where issues had been identified in relation to the audit of the impairment of intangible assets. While most of the issues arising from our prior year review were satisfactorily addressed, we identified some additional issues in the same area of the audit, relating to insufficient evidence for the discount rate assumption and certain required disclosures.

Audits reviewed in the current year

We reviewed and assessed the quality of selected aspects of 14 audits (2010/11: 13). Six of the audits we reviewed (2010/11: nine) were performed to a good standard with limited improvements required; seven audits (2010/11: three) were performed to an acceptable overall standard with improvements required; and one audit (2010/11: one) required significant improvement in relation to the audit scoping for financially significant components of the group (as set out below under "group audit considerations").

An audit is assessed as requiring significant improvement if the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgments in one or more key audit areas, or the implications of concerns relating to other areas are considered to be individually or collectively significant. This assessment does not necessarily imply that an inappropriate audit opinion was issued.

The bar chart below shows the percentage of the audits we reviewed in 2011/12 by AIU grade with comparatives for 2010/11 and 2009/10.



Changes to the proportion of file reviews falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review, changes to the AIU's areas of particular focus and the scope of the individual reviews. For this reason, and because of the small size of the samples involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Findings in relation to audit evidence and judgments

The focus of our reviews was on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk.

We draw attention to the following findings which the firm should ensure are adequately addressed in future audits:

- Group audit considerations
Auditing Standards, applicable from December 2010 financial year-ends, introduced more specific requirements on the conduct of group audits and the firm issued detailed guidance in this area. On the group audits reviewed by us, the written instructions from the group auditor to the component auditors were generally of a good standard.

The group auditor is required to be involved in the component auditors' risk assessment and to evaluate the appropriateness of the audit procedures planned to respond to the identified significant risks. While we were informed that planning discussions and reviews of the component auditors' work had taken place, in five audits there was insufficient evidence of these procedures.

Component materiality is required to be set at a level lower than materiality for the group financial statements as a whole. The basis of the calculation of component materiality was not adequately justified by the group audit team in seven audits and, in one case, the level of component materiality was the same as group materiality.

On one group audit, the extent of the audit scoping for financially significant components required significant improvement, as it was not clear to us that the combination of the work performed by the group audit team and the specified audit procedures undertaken by the component auditors provided an appropriate level of audit evidence.

- Impairment of goodwill and other assets

In response to issues identified in prior years, the firm enhanced its standard work programme in this area. However, we continued to identify issues in relation to the sufficiency of evidence or challenge in relation to the discount rate, growth rate or other key assumptions (five audits) and in relation to the audit of related disclosures (eight audits).

In most of the audits reviewed by us, experts were not used to assist the audit teams in their assessment of goodwill impairment, as the audit teams considered that they had sufficient expertise in that area. However, we were not convinced that this was always the case. We believe that there is a need for further training in this area, as those performing the audit procedures do not always appear to understand all the relevant accounting and financial reporting requirements, for example in relation to the determination of appropriate discount rates and the required disclosures for impairment reviews.

- Revenue recognition

We identified weaknesses in relation to the audit of revenue on eight audits. On four of these audits, the significant risk identified relating to revenue recognition was narrowly defined as applying to cut off only. In two of these audits, where there was a high level of deferred revenue, there were weaknesses in the audit procedures performed to ensure that revenue was recognised in the correct accounting period.

While substantive analytical procedures were generally adequately performed in most respects for revenue, there were weaknesses in relation to aspects of the procedures on six of these audits, such as the basis of the expectations set or the corroboration of explanations obtained from management.

- Related parties

The requirements in Auditing Standards for the audit of related party relationships and transactions were strengthened with effect from December 2010 financial year-ends. The firm enhanced its standard work programme accordingly. However, we identified weaknesses in the audit procedures performed in this area on seven audits. Our findings included insufficient rationale being given for the exclusion of certain individuals from related party disclosures, such as key management personnel.

- Substantive testing sample sizes

On nine audits, sample sizes for one or more areas of substantive testing were determined on a judgmental basis. This included areas of significant risk, or where no reliance was placed on internal controls, and the sample sizes were often relatively small. The firm's audit manual includes guidance on statistical sample sizes; however, there is no guidance on judgmental sample sizes, which audit teams often used as a substitute for the firm's formal sampling methodology.

The risk of excessive use of judgmental sampling for substantive testing purposes is that it may not adequately take into account the significance of the identified risks or the extent of any reliance on controls. The firm should encourage audit teams to make greater use of the firm's methodology for statistical sampling and provide guidance on the use of judgmental sampling.

- Internal experts

Audit teams generally used the work of internal experts in a number of key areas, such as tax and pensions. The firm has a detailed audit programme for tax for completion by the audit team and any experts used in the audit. This was generally fully completed and supplemented by a memorandum from the tax experts. However, on six audits, there were inadequate details of the audit work performed or evidence obtained to support the conclusions of the internal tax experts.

Recurring findings from one year to the next

In response to our prior year findings, the firm has taken steps to achieve improvements. However, recurring findings arose in relation to goodwill impairment assessments (see above) and the audit of financial statement disclosures (see below). The firm should review the effectiveness of its actions in these areas.

Other findings in the current year

Audit of disclosures

We identified weaknesses in the audit of disclosures relating to the impairment of assets (including goodwill and other intangibles), related parties and the accounting policies for intangible assets. On one of these audits the firm's disclosure checklist was completed by the audited entity's staff and reviewed by the audit team; it incorrectly indicated that disclosure requirements had been complied with in an area where there were disclosure omissions in the financial statements.

Communicating with Audit Committees

Reporting to Audit Committees was often of a good or acceptable standard and communications were generally made on a timely basis. In particular, there was a good link between the planned approach to significant risks and reporting on those areas. However, on two audits, a number of outstanding matters were set out in the final report to the Audit Committee, but there was no evidence of any further communications on those areas. In addition, on eight audits, the communication of threats and safeguards for non-audit services was either incomplete or insufficiently detailed.

Auditing Standards require the auditor to communicate significant deficiencies in internal controls identified during the audit on a timely basis. In two audits, not all of the identified significant control deficiencies were communicated to the Audit Committee until well after the approval of the financial statements (nearly three months later in one case, and five months later in the other case).

2.2 Review of the firm's policies and procedures

The firm's policies and procedures are largely developed globally and the UK firm puts significant resources into implementing them; in particular independence compliance and monitoring procedures, risk assessment, the Professional Standards Review ("PSR") function, the audit training and technical communications and the quality monitoring of audit engagements.

The firm took action to address our prior year findings and enhanced its procedures in certain areas. In particular, we note the following improvements:

- Professional scepticism
The firm issued a number of communications to audit personnel on the importance of professional scepticism, included the subject in its mandatory audit training and encouraged its consideration in the performance evaluation process.
- Engagement Quality Control Review (EQCR)
The firm established a group of four senior partners, who are responsible for carrying out the EQCR for nearly all of the firm's FTSE 350 audits, in order to improve the quality of the reviews. As part of our review of this area, we interviewed these partners and found that appropriate planning had been undertaken to ensure they had sufficient time available to carry out this role. The changes have contributed to the quality of the review process by ensuring a more consistent approach.

We identified certain areas for improvement, as outlined below, which need to be addressed.

Findings in the current year

Strategy - focus on quality, growth and efficiency

While the firm's strategy emphasises the importance of maintaining or improving audit quality, it also focuses on growth and audit efficiency initiatives, partly to address audit fee pressures. There is a risk that the quality of future audits may be impacted by these fee pressures and the resulting initiatives to improve efficiencies. The firm should ensure that it continues to focus on audit quality and give particular attention to its audit policies and guidance in areas where the extent of audit procedures performed are dependent on judgments relating to materiality, scoping or sample sizes.

Performance evaluation – consideration of audit quality and link to remuneration

Despite the firm's guidance in this area, nearly all of the staff appraisal forms we reviewed did not include specific objectives and commentary relating to audit quality or technical related competencies. In addition, the firm's guidance on setting audit quality objectives for audit managers and directors included examples which related to other matters instead, such as identifying opportunities to introduce audited entities to other parts of the firm. The guidance should be amended to include relevant examples of audit quality objectives.

The firm's partner quality dashboard summarises each partner's assessed performance in a number of areas, including the results of internal and external quality reviews. This contributes to ensuring that audit quality is taken into account in the partner performance evaluations. However, it was not clear that the performance evaluation and remuneration of the partner responsible for the audit graded by the AIU as "significant improvements required" in the prior year was impacted by this finding. In addition, adverse findings on the quality dashboard for two other partners were not referred to in their appraisal forms.

Partner promotions - Reference to non-audit services to audited entities

We identified two partner promotion candidates who had made reference to non-audit services provided to audited entities in a manner that could be interpreted as seeking credit for success in selling non-audit services. We were informed by the firm that this did not contribute towards the promotion decisions. There was, however, no evidence that the inclusion of this material had been challenged by the Partnership Committee, which decides on the partner promotions. The firm should ensure that there is no misunderstanding by partner candidates about the firm's policy prohibiting recognition for the selling of non-audit services to audited entities and how this is applied in practice.

Technical reviews of the financial statements

A technical review of the financial statements is part of the procedures performed by the firm's Professional Standards Review ("PSR") function for all audits, in addition to a review of other aspects of the audit, prior to the audit report being signed. The firm's technical department is not involved in the technical review of financial statements. While PSR reviews the link between the financial statements and the audit work performed, the reviewers will not always have the same level of technical expertise as those in the firm's technical department.

The output of technical reviews of financial statements is not retained and we have, therefore, not been able to review this output as part of our inspection of completed audits. We believe that retention of the output of technical reviews would contribute towards the audit evidence relating to compliance with financial reporting and disclosure requirements.

Methodology on audit materiality - scoping of account balances

The firm's methodology states that materiality for account balances, classes of transactions and disclosures may be higher than overall materiality and that, if assessed as low risk, these could be scoped out for audit testing purposes. The firm should revise its guidance to ensure appropriate scoping for audit testing purposes and adequate communication of the scoping to Audit Committees.

Independence – monitoring of partner rotation

We continued to identify issues in relation to the accuracy of the firm's rotation database, which forms part of the procedures for monitoring compliance with partner rotation requirements. The firm should take more effective action to address this matter.

Audit quality monitoring

While the firm's findings from its annual review of audits were consistent with those of the AIU in some respects, the grading profile relating to the quality of those audits was more positive. In addition, the firm's reported findings did not identify issues in relation to certain key areas, such as group audit considerations. The firm should ensure that there is sufficient focus on monitoring areas where there have been recurring AIU findings.

The firm also reviews its policies and procedures, based on a standard work programme, on a three year rotational basis, with different areas of the policies and procedures covered every year. While the review covers compliance with a number of Audit Regulations, it is not clear that compliance with all requirements of the Audit Regulations is covered by the firm's monitoring procedures.

Andrew Jones
Director of Audit Quality
Audit Inspection Unit
FRC Conduct Division
15 June 2012

Appendix A – Objectives, scope and basis of reporting

Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. 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.

Our reviews of individual audit engagements and the firm's policies and procedures cover, but are not restricted to, the firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. Our reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.

We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree an action plan with the firm designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified which require action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool. We also assess the extent to which the firm has addressed the findings arising from its previous AIU inspection.

Our inspection was not designed 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.

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

Basis of reporting

This report 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 which the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including Deloitte annually. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's report to the ARC, which was finalised in April 2012, 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. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

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. 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 therefore 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 are selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

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 may be a significant period of elapsed time between completion of the AIU's inspection fieldwork at a firm and the publication of a report on the inspection findings.

The AIU also issues confidential reports on individual audits reviewed during an inspection which are addressed to the relevant audit engagement partner or director. Firms are expected to provide copies of these reports to the directors or equivalent of the relevant audited entities.

Purpose of this report

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 and its 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.

Appendix B – Firm’s response

Andrew Jones
Audit Inspection Unit
Aldwych House
71-91 Aldwych
London
EC2B 4HN

Direct phone: 020 7007 3337
Direct fax: 020 7007 0157
Email: pkakoullis@deloitte.co.uk

31 May 2012
Our ref: PKK/SDL/SMD

Dear Mr. Jones

Public Report on the AIU's 2011/12 inspection Deloitte response

We are pleased to respond to the Audit Inspection Unit's public report on its inspection of Deloitte for the year ended 31 March 2012.

We consider that the AIU's report provides a balanced view of the focus and results of its inspection, and we are therefore pleased to record our agreement with its overall conclusions and findings. The external inspection process provides further impetus to our quality agenda and we confirm that we have implemented a number of actions to respond to the AIU findings.

Deloitte's Audit Transparency Reports provide further, comprehensive information regarding our approach to delivering quality and are available on our website.

Yours sincerely



Panos Kakoullis
Managing Partner, Audit
Deloitte LLP



FINANCIAL REPORTING COUNCIL

5TH FLOOR

ALDWYCH HOUSE

71-91 ALDWYCH

LONDON WC2B 4HN

TEL: +44 (0)20 7492 2300

FAX: +44 (0)20 7492 2301

WEBSITE: www.frc.org.uk

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