



## **AUDIT INSPECTION UNIT**

# **PUBLIC REPORT ON THE 2010/12 INSPECTION OF BAKER TILLY UK AUDIT LLP**

**10 MAY 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.

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

# 1 Background information and key messages

## 1.1 Introduction

This report sets out the principal findings arising from the inspection of Baker Tilly UK Audit LLP (“Baker Tilly” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Financial Reporting Council (“the FRC”), in respect of the two year period to 31 March 2012 (“the 2010/12 inspection”). Our inspection was conducted in June and July 2010 and from May to July 2011 (together 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 six audit engagements undertaken by the firm in our 2010/12 inspection. These related to listed and other major public interest entities, with financial year ends between March 2009 and December 2010. 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 the period of our review, these were: 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 findings on that audit had been addressed in a subsequent 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 period. 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 Baker Tilly in the conduct of the 2010/12 inspection.

## *1.2 Background information on the firm*

The firm is a limited liability partnership operating through 25 offices in the UK. Non-audit services are provided through three separate LLPs and other trading entities, covering tax, accounting and advisory, corporate finance, restructuring and recovery services. The Baker Tilly Group (comprising the four LLPs and other trading entities) is the UK member of Baker Tilly International, described as a global network of independent firms.

For the year ended 31 March 2011, the firm's turnover was £61.8 million. There was a total of 108 partners, of whom 99 were authorised to sign audit reports, and 8 employees who were authorised to sign audit reports.<sup>1</sup>

The AIU estimates that the firm audited 26 entities within the scope of independent inspection by the AIU, under UK company law, as at the 2011/12 reference date of 28

---

<sup>1</sup> As disclosed in the annual return to ICAS as at March 2011.

February 2011. Of these entities, AIU records show that 11 had securities listed on the main market of the London Stock Exchange.

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. The firm currently has no such audits within our scope.

### *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 inspection.

The firm places considerable emphasis on its overall systems of quality control. In many areas the firm has appropriate policies and procedures in place for its size and the nature of its client base. However, we are concerned that, in some areas, actions taken by the firm in response to our prior findings have not adequately addressed the issues previously identified. We have also identified certain other areas where improvements are required to the firm's procedures, which we 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 personnel, 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 and safeguard auditor independence:

- Given the significant emphasis placed by the firm's audit methodology on the performance of substantive analytical review procedures, take more effective action to improve performance in this area.
- Ensure that appropriate action is always taken on a timely basis to address audit quality issues identified by internal and external quality reviews and monitor the effectiveness of these actions.

- Give increased focus and attention to ethical matters, including updating the firm's policies and procedures, providing additional guidance to audit engagement teams and enhancing ethical policies and procedures in certain areas, including rotation monitoring.
- Review the respective responsibilities of, and the relationship between, the Ethics Partner and the firm's Ethics Panel.
- Emphasise the need for audit engagement partners to pay greater attention to the quality and sufficiency of the audit evidence obtained and exercise appropriate professional scepticism, particularly in key areas of judgment such as the recognition of intangible assets, revenue recognition and the valuation of financial assets.

## 2 Principal findings

The comments below are based on our reviews 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 inspection*

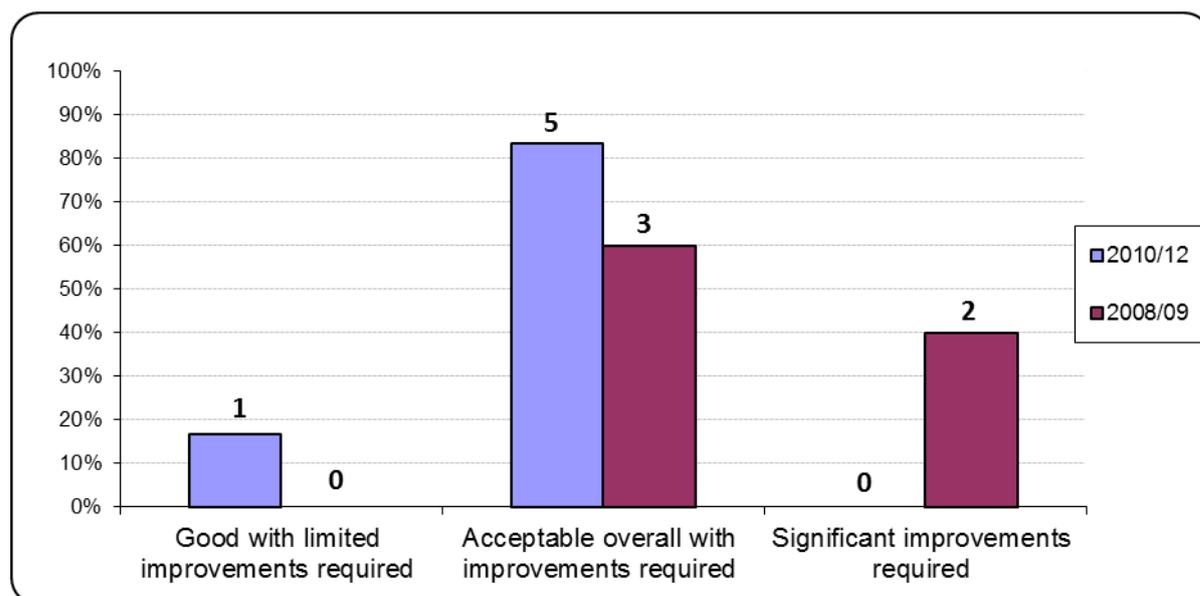
We undertook one follow-up review of an audit we had reviewed in our prior inspection. The issues we raised previously had been addressed on this audit which resulted in improvements to audit quality in the relevant areas.

#### *Audits reviewed in the current period*

We reviewed and assessed the quality of selected aspects of six audits.

One of the audits we reviewed was performed to a good standard with limited improvements required. The other five audits were performed to an acceptable overall standard with improvements required.

The bar chart below shows the number and percentage of audits we reviewed in 2010/12 by AIU grade with comparatives for 2008/9.



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.

Changes to the proportion of file reviews falling within each grade from period to period 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 period 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 has been 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:

- Audit evidence and the exercise of professional scepticism

We identified issues in relation to the sufficiency or quality of audit evidence in key areas on five audits reviewed, including in relation to key areas of judgement such as deferred revenue, intangible assets and asset valuations. These issues suggest that more needs to be done to promote the appropriate exercise of professional scepticism, in particular in relation to the level of challenge of management's explanations.

- Substantive analytical review

The firm's audit methodology places significant emphasis on the performance of substantive analytical review procedures, which are considered mandatory. The substantive analytical review performed for certain account balances was inadequate in five of the audits reviewed. In all cases the expectations set were insufficiently precise and, in four of the five cases, there was a lack of adequate corroboration of variances identified. The emphasis placed by the firm on the use of analytical review procedures to obtain audit evidence means that deficiencies in their performance are likely to have implications for the overall adequacy of the audit evidence obtained in particular areas. The firm must, therefore, take further and more effective action to address this issue.

- Testing of journal entries

On five audits, insufficient audit procedures were performed relating to the testing of journal entries. On four of these audits, there was insufficient evidence of year end journal testing. On three of these audits and one further audit, there was insufficient consideration of whether journals should be tested at other dates during the year.

*Recurring findings from one period to the next*

While we have seen some improvement in relation to the following matters, following a number of positive steps by the firm, the matters noted below continue to require improvement:

- Sufficiency and quality of audit evidence

By the time of the relevant audits, the firm did not appear to have taken effective action to address our previous findings relating to the sufficiency and quality of audit evidence (as detailed above).

- Significant risks

We previously reported that there was insufficient assessment of the design and implementation of controls in relation to significant risks. While action was taken by the firm, including providing additional guidance and training on this area, issues were identified on four audits reviewed in the current inspection.

- Cross-referenced set of financial statements

We previously recommended that audit teams attach a fully cross-referenced set of the financial statements, including notes, to the audit files. Three audit files reviewed in the current inspection, for which deficiencies in the audit evidence obtained were identified, did not contain a cross-referenced set of financial statements. Strengthening procedures in this area should assist in identifying areas where there are deficiencies in the quality of audit evidence obtained.

*Other findings in the current period*

*Communicating with Audit Committees*

Subject to our comments below, reporting to Audit Committees or their equivalent was generally performed to a satisfactory standard and communications were made on a timely basis.

On two audits where there was no Audit Committee, audit matters were not reported to the whole Board. On another audit, independence threats arising from the provision of non-audit services were not adequately assessed and reported.

## *2.2 Review of the firm's policies and procedures*

The firm's policies and procedures are developed on a national basis and, since our previous inspection, the firm has moved to a more centrally managed structure with day to day responsibilities resting with a dedicated management team.

The firm has also emphasised the role of Audit Quality Champions at each office through the introduction of detailed job descriptions enhancing their authority and responsibilities, development of specific training and by encouraging benchmarking of best practice.

These and other changes since our previous inspection provide evidence that the firm is committed to continuous improvement in audit quality.

The firm requires individuals to obtain an internal authorisation before they are permitted to act as an audit engagement partner. Additional specialist authorisation is required for audits of listed companies and entities in certain specialist sectors. A mentoring process is in place for newly authorised partners. The partner authorisation and mentoring processes should contribute to improving audit quality.

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

### *Progress on dealing with prior period findings*

The firm has made progress in acting on our findings from previous inspections and a number of improvements have been made to its procedures as a result. However, prior inspection findings in a number of areas have not been adequately addressed.

We expect the firm to take effective action on a timely basis to address the outstanding matters set out below.

- Rotation monitoring

We previously reported that improvements to the firm's rotation policies and procedures were required. For unlisted audit clients, the length of involvement of the audit engagement partner and the allocation of an independent review partner where appropriate were monitored using spreadsheets. These spreadsheets were not

maintained in the current year as the data is now recorded in the firm's electronic audit system, which then automatically introduces relevant procedures relating to the independent review process. The accuracy of this data was not monitored. At our request, the firm reviewed the accuracy of data in the electronic audit system and identified that in five cases the required independent partner review had not been completed.

- Training and professional development

A number of cases were identified where partners and staff had not attended mandatory training courses. We were informed that some of these individuals had subsequently read the course material and/or taken a post-course test, while others provided reasons for non-attendance. The firm's audit quality monitoring department also assesses attendance and has confirmed that most partners and staff attended the mandatory courses. However, the firm's processes for ensuring appropriate attendance remain inadequate.

- Risk assessment

As part of the audit planning process, an Audit Risk Questionnaire is completed to determine an overall audit risk. This overall risk assessment affects the audit approach and level of audit testing required. In our view, a central assessment should be performed of the appropriateness of the audit risk classifications and whether the system identifies all the firm's high risk audits.

- Client service partners

The firm appoints client service partners for all clients to take responsibility for the overall client relationship including oversight of the provision of non-audit services. For listed entities, the audit engagement partner is often appointed to this role. At the time of our inspection, the firm had not taken action to clearly define the nature of the client service partner role for listed entities audited by the firm.

In one case, a client service partner who had previously been involved in the audit continued to attend Audit Committee meetings. This may give rise to a perception that he is able to exert inappropriate influence on the conduct and outcome of the audit. In addition, it was inappropriate in such circumstances for the partner to have accepted significant hospitality from the client on a number of occasions during the year.

## *Other findings in the current period*

### *Ethics Partner role*

Ethical Standards require the appointment of a partner in the firm (the Ethics Partner) to take responsibility for the firm's ethical policies and procedures and the application of Ethical Standards within the firm. While the firm's Ethics Partner has significant relevant experience, he is not a member of the firm's leadership team and does not chair the firm's Ethics Panel. It is, therefore, not clear that the firm's Ethics Partner has appropriate authority at leadership level within the firm to effectively perform the role.

### *Partner joining an audit client*

In 2010 the firm permitted an audit partner to join an audit client as Finance Director within two years of his involvement in the audit ceasing and did not resign from the audit as required by Ethical Standards. A similar case had occurred in 2008. We regard this as a serious matter and referred it to the relevant professional body.

### *Ethical policies, procedures and guidance*

We identified a number of Ethical Standard requirements not explicitly included in the firm's policies and procedures where specific guidance has not been provided by the firm to audit engagement teams.

### *Transparency Report*

The firm appointed the Ethics Partner and a former partner (who ceased to be a partner in the firm 9 years previously) as "independent non-executives" under the Audit Firm Governance Code in 2011. The firm's Transparency Report did not adequately explain how an individual who continues to fulfil an executive role within the Baker Tilly Group can perform effectively an independent non-executive role.

### *Performance evaluation and remuneration*

Our discussions with the firm's senior management indicated that it was possible to identify some link between audit quality indicators, as evidenced through appraisal forms or results and feedback from the firm's audit quality monitoring process, and changes to the overall remuneration package for an individual. However, there is no explicit link between audit quality indicators and changes in partner remuneration.

### *Engagement Quality Control Review*

The firm's "Hot Review" process for audits assessed as high risk incorporates both a technical review of the financial statements and the Engagement Quality Control Review ("EQCR"). It is carried out by specialists in the National Audit Technical department. Only an individual authorised to sign audit reports can assume responsibility for the EQCR element of the Hot Review.

In 2009, an employee newly authorised to sign audit reports assumed overall responsibility for the Hot Reviews of a number of audits within AIU scope, including the EQCR element. The firm should have policies in place to ensure that the Hot Reviewer for the firm's higher risk audits has a sufficient level of authority within the firm.

### *Materiality*

Auditing Standards require audit teams to determine materiality for the financial statements as a whole ("overall materiality"), together with a lower performance materiality for the purposes of determining the nature, timing and extent of audit procedures. Performance materiality is set to reduce to a low level the risk that the aggregate of uncorrected and undetected misstatements exceeds overall materiality.

While the firm's methodology provides for both an overall materiality level and performance materiality level to be determined, in our view the firm's approach results in too high an overall materiality figure. We were informed that the firm has instructed audit teams to ignore this figure and instead use the lower performance materiality figure at all times. Such guidance is inconsistent with the rationale underlying the relevant Auditing Standard requirements and should therefore be revised.

### *Response to significant concerns arising from audit quality monitoring*

Our review of the firm's audit quality monitoring process indicated that it is comprehensive in coverage and appears to be thorough in its identification of issues.

Significant concerns identified by the firm's audit quality monitoring process are reported to the National Audit Technical department who determine the action required. We identified, however, that appropriate action had not been taken on a timely basis in a number of cases following the identification and reporting of audit quality issues.

Andrew Jones  
Director of Audit Quality  
Audit Inspection Unit  
FRC Conduct Division  
10 May 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 is 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 of Scotland ("ICAS") with which the firm is registered for audit purposes. The AIU currently inspects Baker Tilly over a two year cycle. 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 February 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 period. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

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 period 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 period. 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**

25 Farringdon Street  
London  
EC4A 4AB  
Tel: +44 (0)20 3201 8000  
Fax: +44 (0)20 3201 8001  
DX: 1040 London/Chancery Lane  
www.bakertilly.co.uk

Audit Inspection Unit  
71-91 Aldwych  
London  
WC2B 4HN

1 May 2012

Dear Sirs

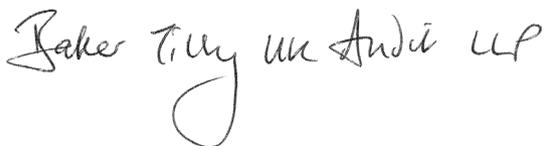
**AIU Public Report on the 2010/12 Inspection of Baker Tilly UK Audit LLP**

We appreciate the opportunity to respond to the AIU's report. We are resolutely committed to the improvement of audit quality and we are pleased that the report recognises this commitment.

We welcome any recommendations that will contribute to an improvement in audit quality. We have already taken action to address many of the AIU's findings, which we had already identified through our own quality assurance procedures, although the timing of the AIU's file reviews was such that it would not have been possible to see the effects of these actions. We continue to take additional action to further address these and other areas, as set out in the action plan agreed between us.

We are pleased with the AIU's assessment that none of the audits inspected required significant improvements but nonetheless we will continue to strive to achieve further improvements in the quality of all our audits.

Yours faithfully



**Baker Tilly UK Audit 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](http://www.frc.org.uk)**

© The Financial Reporting Council Limited 2012

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368.  
Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.