



## **AUDIT INSPECTION UNIT**

# **PUBLIC REPORT ON THE 2010/12 INSPECTION OF PKF (UK) 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.

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# 1 Background information and key messages

## 1.1 Introduction

This report sets out the principal findings arising from the inspection of PKF (UK) LLP (“PKF” 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 the period from March to April 2011 and August to December 2011 (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 seven audit engagements undertaken by the firm in our 2010/12 inspection. These related to listed and AIM listed entities, with financial year ends between February 2010 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: 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 findings on the 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 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 PKF in the conduct of the 2010/12 inspection.

## *1.2 Background information on the firm*

PKF is a UK limited liability partnership. It is a member of PKF International Limited which is described as a "network of legally independent firms".

PKF has 22 offices throughout the UK. Assurance and advisory services are managed within each office, whereas certain other specialised types of work are managed across offices.

For the year ended 31 March 2011, the firm's turnover was £108 million, of which £46 million related to assurance and advisory services. There were a total of 121 partners, of whom 48 were authorised to sign audit reports<sup>1</sup>.

The AIU estimates that the firm audited 49 entities within the scope of independent inspection by the AIU, under UK company law, as at the 2011/12 reference date of 28

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<sup>1</sup> As disclosed in the annual return to the ICAEW as at 31 May 2011.

February 2011. Of these entities, AIU records show that 37 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 two 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 have identified certain 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:

- Give increased focus and attention to the audit of impairments, in particular ensuring that the impairment assessment and sensitivity calculations are obtained from the audited entity and appropriate audit procedures are performed.
- For group audits, where all or significant portions of the Group's operations are outside of the UK, ensure that there is timely and appropriate involvement in all aspects of the work performed by the component auditors.

- Give increased focus and attention to the audit work performed in respect of disclosures.
- Ensure that audit personnel properly identify the nature of non-audit services being provided and the related threats arising, including considering the cumulative threat to independence arising from the provision of multiple non-audit services and other independence matters.
- Ensure that credit is not sought or given in staff appraisals for success in selling non-audit services to audited entities.
- Monitor progress in the above areas by including them as specific aspects for consideration in the firm's quality review process.

## 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

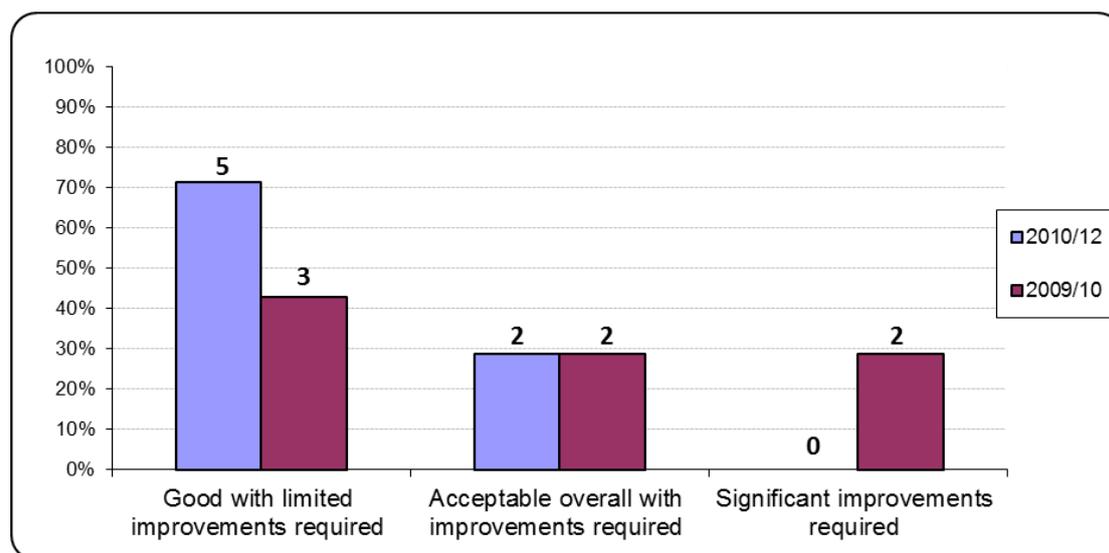
#### *Follow-up of audits reviewed in the prior inspection*

We undertook one follow-up review of an audit we had reviewed in the 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 selected aspects of seven audits and assessed the quality of those aspects of the audit. Five of those audits were performed to a good standard with limited improvements required and two of those audits were performed to an acceptable overall standard with improvements required.

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



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 of impairments  
Issues relating to the sufficiency of audit evidence obtained for key judgments over the impairment of deferred costs and goodwill were identified in a number of areas on four audits reviewed.
- Group auditing considerations  
In two group audits reviewed, where all or significant portions of the Group's operations were outside of the UK, there was insufficient evidence of the group auditors' involvement in aspects of the work performed by the component auditors. In one audit, we noted weaknesses in the work performed by the component auditor which had not been followed up.
- Confirmation of cash balances  
In two audits, insufficient consideration was given to requesting and obtaining third party confirmations of cash balances either held at overseas banks, from whom the audit team considered that a response might not be received, or held in an escrow account.
- Audit of disclosures  
In five audits, insufficient or no audit work was performed in respect of certain disclosures. These included disclosures concerning related party transactions, long term contracts, financial instruments and operating leases.

### *Recurring findings from one period to the next*

The firm has taken action in respect of our prior inspection findings in respect of audit performance. However, we continued to identify areas where insufficient audit evidence was obtained, particularly in relation to asset impairments and certain omissions/deficiencies in the reporting to Audit Committees/Boards, as noted below.

The firm should assess the effectiveness of its actions in these areas and take additional action, as appropriate, until these issues have been resolved.

### *Other findings in the current period*

#### *Reporting of audit findings to the Audit Committee/Board*

In two audits, the auditor's final views were not communicated to the Audit Committee/Board. Further, in one of these audits and in a third audit, the auditor discussed the significant findings arising from the audit with the Audit Committee/Board on the day that the approval of the Annual Report was expected to take place. Communication of the auditor's final views on a timely basis to the Audit Committee/Board ensures that any significant matters arising are considered fully by the Audit Committee/Board prior to the approval of the Annual Report.

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

There are regular communications from senior partners to audit teams emphasising the firm's focus on audit quality and demonstrating the firm's commitment to continuous improvement in audit quality.

The firm requires partners to obtain an internal licence before they are permitted to act as an audit engagement partner and specific additional licences are required for the audits of listed companies and entities in certain specialist sectors. All partners who act as Engagement Quality Control Reviewers ('EQCR') are also required to hold a full audit licence. The firm's Internal Quality Control Review ('IQCR') process is integrated with the partner licencing system. Partners who do not meet the required standard, based on the evidence from the IQCR process, may be subject to enhanced internal review procedures until improvements in audit quality are achieved. The firm's licensing 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 acted on most of our findings from prior inspections. Our prior inspection findings in the following areas, however, have not been fully addressed.

- Standard approach for documenting staff appraisals

The implementation of a new competency framework and Performance Review and Development process has been delayed and is now being rolled out in 2012.

- Audit reports

The firm's consultation policy requires all non-standard audit reports to be reviewed by a second partner, which is often the EQCR, or by the technical department. Our previous report recommended that consultation and review by the firm's technical department be required in respect of all non-standard audit reports. The firm informed us that it is keeping this under review. However, we consider that a periodic review of non-standard audit reports should be performed to assess the effectiveness of the current policy.

### *Other findings in the current period*

#### *Professional scepticism*

The findings of our file reviews indicate that the firm needs to continue to focus on promoting the exercise of appropriate professional scepticism in practice, including in assessing the impairment of goodwill and intangible assets.

#### *Ethical consultations*

Consultation with the Ethics Partner is required by the firm in a variety of circumstances. In respect of a number of consultations with the Ethics Partner, the central record did not clearly set out the rationale for the final decision or record the final conclusion reached by the Ethics Partner.

The Ethics Partner is consulted on an annual basis when an audit engagement partner for a non-listed entity has been in the role for more than ten years. However, the Ethics Partner should also consider other independence threats arising, such as the provision of non-audit services, in determining the adequacy of safeguards to be applied in these circumstances.

### *Non-audit services – consideration of threats and safeguards*

The firm's consideration of threats to independence arising from the provision of non-audit services and related communications with those charged with governance did not always set out the exact nature of the services provided, identify the specific threats that arose or the specific safeguards implemented. It was, therefore, difficult to assess whether the safeguards put in place were sufficient to mitigate the threats arising.

For example, the safeguard applied in five audits (none of which are within the AIU's scope), where the same team both prepared and audited the financial statements, was for an independent partner/manager to review the accounts preparation. The nature of the self-review threat arising on each audit was not set out and, therefore, it was not clear how the firm had concluded that this was an effective safeguard.

### *Performance evaluation*

Our review of staff appraisal documentation identified a number of cases where staff appeared to seek credit or expect credit to be given for cross-selling non-audit services to audit clients.

There was still some inconsistency in the level of detail in staff appraisal documentation and no specific comments were made on achievement against prior year objectives. The objectives set for the following year were in many cases brief and non-specific; it was, therefore, difficult to see how they would be measured.

There was also no clear link between audit quality indicators included in staff appraisals and staff progression or remuneration.

### *Consideration of country risk factors in risk assessments*

In two audits where the country of main operation was recognised as experiencing high levels of corruption, there was no explicit consideration of these country risk factors in assessing the level of risk associated with the audit. Consideration of these country risk factors may have resulted in a higher risk assessment which would have required these entities to be monitored at a higher level within the firm.

*Effectiveness of the EQCR process*

Our file reviews indicate that there are certain areas where more robust challenge by the EQCR, or a refocusing of their review to cover different areas, would have improved the effectiveness of the process.

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 in England and Wales ("the ICAEW") with which the firm is registered for audit purposes. The AIU currently inspects PKF 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 March 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 period 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**

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Aldwych House  
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London  
WC2B 4HN

2 May 2012

Dear Sirs

**Public Report on the AIU's 2010/12 Inspection**

We welcome the publication of this report on our firm and its recognition of the emphasis we place on our overall systems of quality control.

We operate to high standards and we commit substantial resources to ensuring that we continue to do so. We believe that this report reflects our commitment in this respect.

Nevertheless, we are not complacent and we continue to develop our processes around quality work.

Our Transparency Report, which is available on our website, provides further information on the way we are continuing to drive quality.

We would like to take this opportunity to thank the AIU for the constructive approach it adopts in its relationship with us.

Yours faithfully



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PKF (UK) LLP is a limited liability partnership registered in England and Wales with registered number OC310487.

A list of members' names is open to inspection at Farringdon Place, 20 Farringdon Road, London EC1M 3AP, the principal place of business and registered office. PKF (UK) LLP is authorised and regulated by the Financial Services Authority for investment business activities. PKF (UK) LLP is a member firm of the PKF International Limited network of legally independent firms and does not accept any responsibility or liability for the actions or inactions on the part of any other individual member firm or firms.



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