

BDO LLP

AUDIT QUALITY INSPECTION

JUNE 2018

The FRC

Our mission is to promote transparency and integrity in business.

transparency



We have responsibility for the public oversight of statutory auditors.

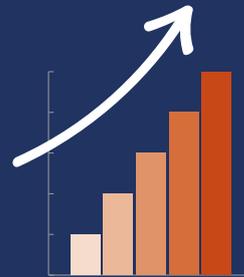
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



AQR

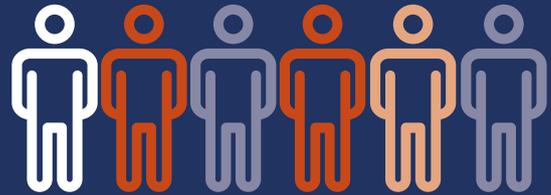
We monitor the quality of UK Public Interest Entity audits.

+1.55	0.20%	+2.27%	-11.48%	POS	-3.2320
+3.20	0.21%	+2.83%	-15.93%	NEG	-3.9993
+3.85	0.14%	+2.42%	-17.67%	POS	-4.2421
+3.38	0.17%	+2.19%	-18.32%	NEG	-4.2083
+3.22	0.37%	+2.28%	-14.73%	NEG	-3.5708
+3.31	0.20%	+2.76%	-20.12%	NEG	-2.8339



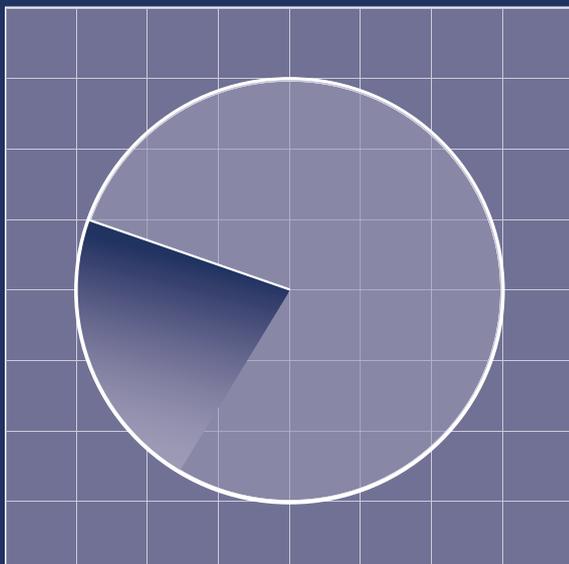
We promote continuous improvement in audit quality.

Our team of over 40 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



The Firm

BDO LLP has 117 audits within the scope of AQR inspection, including 5 FTSE 250 audits.



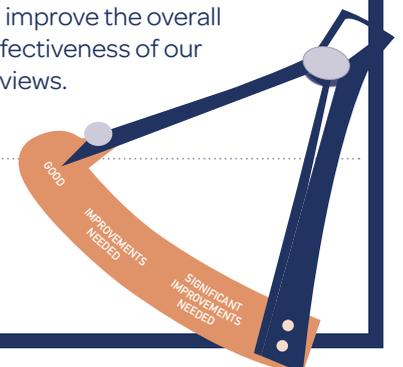
Our inspection process

There are around 2350 audits within the scope of AQR inspection. In total, we inspected 145 individual audits in 2017/18, including 8 at BDO.



We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of each individual audit reviewed.



Financial Reporting Council

BDO LLP

Audit Quality Inspection

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AQR's objective is to monitor and promote improvements in the quality of auditing.

AQR assesses the quality of audit work and policies and procedures supporting audit quality at firms which audit Public Interest Entities.

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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1 Overview

This report sets out the principal findings arising from the 2017/18 inspection of BDO LLP (“BDO” or “the firm”) carried out by the Audit Quality Review team (“AQR”) of the Financial Reporting Council (“the FRC”). We conducted this inspection in the period from February 2017 to January 2018 (“the time of our inspection”). We inspect BDO, and report publicly on our findings, annually.

Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm’s audit work. Our findings cover matters arising from our reviews of both individual audits and the firm’s policies and procedures which support and promote audit quality, focusing on changes arising from the revised Auditing and Ethical Standards¹. We plan to enhance our monitoring of the six largest firms, including BDO, from 2018/19².

We are grateful for the co-operation and assistance received from the firm’s partners and staff in the conduct of our 2017/18 inspection.

Our assessment of the firm’s performance

The results of our reviews of individual audits show a continued improvement in recent years, with seven of the eight audits reviewed requiring no more than limited improvements. We have seen an improvement in relation to some of the key findings highlighted in last year’s report, although we continue to identify shortcomings in certain areas (for example, the quality of communications with Audit Committees on significant findings).

The firm had revised most its policies and procedures in response to the revised Ethical and Auditing Standards. At the time of our review, however, the firm’s systems and procedures for the monitoring of personal financial interests, and for implementing certain other requirements of the revised Ethical Standard, required improvement.

Key findings in the current year requiring action

Further details of all our key findings are given in section 2, together with the firm’s actions to address them.

Our other key findings in the current year requiring action by the firm are set out below.

¹ The firm was also included within the scope of our thematic review on Audit Firm Culture. The report, published in May 2018, sets out how audit firms are seeking to embed a culture which supports high quality audit: [Audit Culture Thematic Review](#)
² [AFMA Press Notice](#)

Review of firm-wide procedures

The firm should:

- Improve the timeliness of its training for revised Auditing Standards.

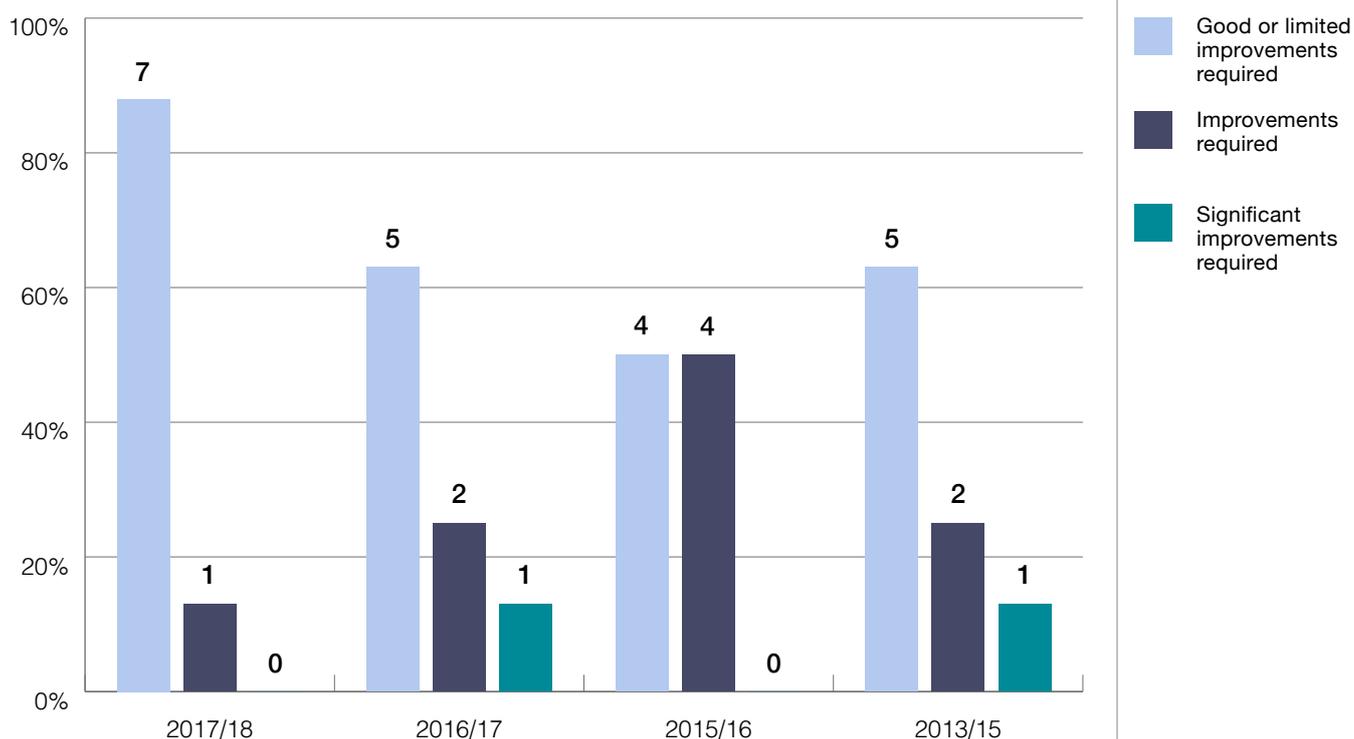
Individual audit reviews

The firm should:

- Achieve greater consistency in audit quality control and review procedures.
- Improve the evidence of appropriate challenge in relation to areas of audit judgement.

Assessment of the quality of audits reviewed

The bar chart below shows the results of our assessment of the quality of the audits we reviewed in 2017/18, with comparatives for our three previous inspections³. The number of audits within each category in each period is shown at the top of each bar.



³ Changes to the proportion of audits falling within each category 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 and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Good practice identified

Examples of good practice we identified in the course of our work include:

- Consultation on and review of all extended audit reports.
- The use of, and coordination with, internal specialists to assess key valuation assumptions.
- Obtaining independent evidence to determine appropriate property valuations.
- The use of a combination of substantive analytical procedures and tests of detail in the audit of revenue.

More detailed comments on good practice, together with the firm's progress in response to our 2017 report, are set out in section 3.

Root cause analysis

Thorough and robust root cause analysis (RCA) is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

Our report on Audit Firm Culture stated that, based on RCA undertaken through 2017, all firms covered by that review had improved their RCA since our 2016 thematic review. We also reported that firms should seek to develop their RCA techniques "to identify the behavioural or cultural factors that contributed to either good or poor quality outcomes".

The firm has performed RCA in respect of the key findings arising from our reviews of individual audits and considered the outcome in developing the actions included in this report. Further details on the RCA process are included in section 3. We will continue to assess the effectiveness of the firm's RCA process and encourage all firms to develop their RCA techniques further.

Firm's overall response and actions:

As noted by the FRC in this report we have spent significant resource and time developing a root cause analysis process that is now well embedded within the audit stream.

We considered the individual audit file review findings and decided to also include those from our internal Audit Quality Assurance Review. We performed root cause analysis investigations on sufficiency of involvement of the engagement partner in the audit and sufficiency of audit evidence included on the audit file. Although we undertook some immediate actions (and these are noted in more detail as a response to the individual points), there are a number of issues, some of them behavioural, that continue to be identified as root causes on a number of our investigations and have an impact on audit quality. We will be sharing the themes arising from the RCA with the more senior members of the audit stream in each local business unit in order for them to determine what initiatives could be implemented locally.

Firm's overall response and actions:

In addition, the Audit Stream Executive will be considering how to better recognise and reward high quality performance.

In relation to the firmwide findings, we did not perform root cause analysis as we considered the nature of these findings did not lend themselves to this. However, in relation to the training point, we now have a clearer process in place for communicating the timing of intended training.

In addition to the investigations performed above, we also undertook RCA on the highest graded files. In doing so we identified useful learning points from the audit teams reviewed.

We were not surprised by the similarities to the approach taken on these audits. This highlighted not only that they were doing what was expected of them by the standards but that their approach could be replicated by other teams. In undertaking this exercise, we identified some key areas that contribute towards higher audit quality:

- Involvement of senior members of the audit team – a key element was involvement from the initial briefing, to setting of expectations, to early detailed planning, on the job training and review contributing to high audit quality.
- Continuity of the team – where the composition of the team was carefully considered at an early stage and where there was continuity this helped to improve the quality of the file as there was greater depth of understanding and hence ability to challenge the management of the audited entity.
- Documentation of the file – where the expectation is set up front that the file will be ready to archive on audit sign off this made the task of review much easier and more effective and assisted in demonstrating the good work performed by the audit team so resulting in a better quality file.
- Good Project Management – this was a key element to ensure audit quality as essentially it meant the right person, doing the right work at the right time. This extended to the involvement of others such as experts and specialists in the audit and ensured they were given clear, documented instructions up front and their work was properly integrated into the audit.
- Sector best practice – where good testing strategies were developed on engagements in certain sectors this was then communicated within the sector to help establish good practice resulting in a high standard of audit work.

We have shared and discussed these findings within the audit stream as they highlight the benefits of following consistent working practices.

2 Key findings requiring action and the firm's response

We set out below the key areas where we believe improvements are required to enhance audit quality and safeguard auditor independence. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Review of firm-wide procedures

Strengthen the firm's systems for implementing certain requirements of the revised Ethical Standard (ES)

Firms needs to implement policies and procedures to safeguard auditor independence. A revised ES became effective during the year with enhanced requirements and stricter prohibitions.

Given the importance of auditor independence and the impact of the revised ES, in March 2017 we reviewed the arrangements for independence and ethics at the six largest audit firms. This approach allowed us to benchmark arrangements across the firms and share good practice. Our review focused on how the firm's policies and procedures address the revised ES requirements. We have also reviewed compliance with the previous Ethical Standards as part of our inspections of individual audits.

The firm had made progress in addressing the new ES requirements, including updating most of its policies and procedures. At the time of our review, however, improvements were required to strengthen the firm's ethics and independence procedures, in particular for the monitoring of personal financial interests.

Findings

We identified the following concerns:

- The firm does not have a system for partners and staff to record their financial interests. It is heavily reliant on manual controls and on individuals managing their financial affairs appropriately to prevent and detect prohibited investments (for example, the firm's prohibited entities list relies on engagement partners notifying any changes).
- The firm's compliance testing of all partners relating to prohibited financial interests is planned over a three year period. However, the scope of the firm's testing did not address higher risk individuals such as partners with prior year findings, internally promoted partners or new hire partners in their first year with the firm. In addition, the firm does not perform any testing of its staff's financial interests.

- The firm’s monitoring of partner and staff rotation (to safeguard the independence of audit teams) requires a number of improvements. This includes addressing new and revised categories of partners, as well as taking account of previous roles, cooling-off periods and cumulative periods of audit involvement.
- The ES has redefined key audit partners (KAPs) and reduced the rotation period from seven years to five years, adding complexity to applying these requirements to group audits. The firm does not have a mandated policy to apply these rotation requirements to non-EU based partners where they are involved in the group audit of a UK Public Interest Entity (PIE), although in practice they are being applied.
- The firm was not monitoring communication of ethical and independence breaches to Audit Committees.
- Although a meeting had taken place between the Ethics Team and each audit partner who was responsible for PIE audits, at the time of our review the firm’s mandatory classroom-based detailed training on the revised ES for all relevant partners had yet to take place. Further, completion of the e-learning provided for staff (excluding directors) was not mandatory and did not require obtaining a test pass.

Firm’s actions:

In relation to the points raised above, we note:

- Our system of monitoring staff financial interests in both recording and monitoring has been reviewed by the Quality and Risk Management Committee and the Leadership Team. It has been decided that the extent of monitoring should be increased and revised to prioritise higher risk individuals and that IT systems for recording financial interests should be evaluated.
- The firm extended compliance testing of financial interests to all staff at the beginning of April 2018.
- Whilst it is true that the firm has not published a formal policy regarding rotation requirements for non-EU based partners, we have only a relatively small number of clients that are impacted and as noted by the FRC we are currently treating all non-EU partner on material subsidiaries as KAPs. Therefore, as far as application is concerned, this is achieving the same outcome.
- We do now monitor the communications of ethical and independence breaches to audit committees should this be necessary.
- During the 2016 Quality and Risk roadshows, to which attendance was mandatory, we covered the revised Ethical Standard. The Test of Knowledge included in the suite of ISA training in autumn 2017 on the revised ISAs and ES was also mandatory and included questions specifically in relation to the ES.

Improve the timeliness of the firm's training for revised Auditing Standards

The revised Auditing Standards have a number of additional requirements. Adequate training for partners and staff is necessary to ensure that they adequately understand the new requirements and comply with them in practice.

At the time of our review in March 2017, the firm's planned response to training for the revised Auditing Standards was not well-advanced. The firm has since made progress in addressing the new requirements of the revised standards and updating its policies and procedures.

The firm's training on the new auditing standard requirements was not comprehensive. Specifically, we noted that training was still being developed for Engagement Quality Control Reviewers (EQCRs) and internal specialists. In addition, training was still required to address the new requirements on going concern.

The training was made available to partners and staff on a "just in time" basis for December 2017 year end audits. Individual training was, however, provided to audit teams where the revised Auditing Standards applied to audits of earlier year ends.

Firm's actions:

We believe that training is most effective when provided as close as possible to implementation. This allows audit teams to apply their learning immediately when it is fresh in their minds and reinforce their understanding by performing practical application.

In respect of Going Concern and EQCRs, materials were rolled out to the stream in November 2017 and December 2017 respectively.

In relation to future training requirements, we now have a clearer process in place for communicating the timing of intended training.

Individual audit reviews

Achieve greater consistency in audit quality control and review procedures

Auditing Standards require that the partner should review audit documentation and hold discussions with the audit team to determine whether sufficient and appropriate audit evidence has been obtained to support the conclusions reached. For significant judgements, the EQCR should also review selected audit documentation.

We reviewed aspects of the quality control and completion procedures on all the audits that we inspected. We noted one audit where the partner and EQCR review processes were not sufficiently rigorous and so did not identify areas where audit evidence was inadequate. Their review should have led to sufficient and appropriate evidence being included in the audit documentation.

Firm's actions:

There were particular circumstances in relation to the audit identified above that have been addressed within the team. However, on a broader note we highlighted in our comment earlier the importance of senior team involvement in the audit process for both guidance and review. We believe the new processes we have implemented for all EQCR appointments as a result of the revised ISA (UK) 220 will help to ensure that the EQCR is able to fulfil their quality control role rigorously. We will be considering whether the mandatory engagement partner documentation could be enhanced further.

Improve the evidence of appropriate challenge in relation to areas of judgement

The valuation of assets and the recognition of provisions in the financial statements rely on key assumptions made by management. These are often judgemental and the resulting valuations and provisions can be sensitive to small changes in those assumptions. Audit teams should therefore obtain sufficient and appropriate evidence to assess the reasonableness of those assumptions and provide an appropriate level of challenge to management.

Given the level of audit risk and the potential impact on the financial statements, we reviewed the audit of asset valuations and provisions on most of the audits that we inspected. The audit work was often performed to a good standard, but we did identify findings on some of the audits including the following examples:

- Insufficient evidence to support how audit teams had concluded on the appropriateness of certain valuation and provision assumptions.
- Insufficient challenge to management in respect of the appropriateness of the level of inventory provisions.

Firm's actions:

Inclusion of appropriate evidence of challenge and audit evidence is one of the qualities of a good audit file. Root cause analysis in this area suggests that the insufficiency of evidence on the file either stems from evidence being obtained but not being put on the file or inappropriate assessment by members of the audit team of the sufficiency of the evidence obtained.

We are undertaking a number of actions in order to address this issue:

- Refreshing our guidance as to what evidence is required, in various scenarios such as challenge of management, to be added to the audit file – there is some inconsistency in the way different teams deal with audit evidence which leads to issues arising.
- Understanding the evidence, we need in particular in relation to judgemental areas where we are dealing with assumptions and estimations and how this is to be presented in the file is a key element of the planning stage of the audit. The Audit Stream Executive will consider a number of proposals to ensure planning is a key focus of each audit team.

Continue to improve the quality of written communications with Audit Committees on significant findings

Auditors need to communicate relevant matters clearly to Audit Committees, to assist them in overseeing the financial reporting process, assessing management's significant judgements and discharging their governance responsibilities.

We reviewed communications with Audit Committees on all audits that we inspected. We continue to find examples of good communication. However, on some audits reviewed insufficient detail was reported to Audit Committees on certain significant findings. Specific examples were:

- In certain key areas, the report did not clearly set out the audit evidence supporting management judgements.
- The difference between the audit team's stock variance estimate and management's estimate was not reported.
- The information provided to the Audit Committee on the work performed by the audit team's specialist was potentially misleading.

Firm's actions:

We did not undertake root cause analysis in relation to this point as we performed a detailed investigation in this area as a result of the 2016/17 AQR report. We note that the AQR found good examples of communications. The firm has recently invested in resources in this area including the development of a reporting tool to produce high quality communications to those charged with governance. We continue to share good examples of communications throughout the stream to demonstrate 'what good looks like' and the level of detail that is required to ensure these communications can be used as necessary by audit committees to allow them to fulfil their responsibilities.

3 Good practice examples and developments in the year

Good practices

We set out below the key areas where we noted examples of good practice, either from our review of audit work on individual engagements or from our review of firm-wide procedures.

Review of firm-wide procedures

Extended audit report reviews

The firm's requirement for extended audit reports to be reviewed centrally is to be widened to cover the increased population of PIEs arising from the UK's implementation of the EU Audit Regulation and Directive.

Individual audit reviews

The use of, and coordination with, internal specialists

Audit teams often use internal specialists to provide audit evidence in support of key assumptions, particularly valuations. We found examples of good practice involving the use of, and coordination with, internal specialists to assess key valuation assumptions for investments and pension scheme liability valuations.

Independent evidence to determine appropriate valuations

The quality of audit evidence is improved by obtaining independent evidence to assess valuations and provide challenge. The audit team obtained independent evidence to support their own property valuations, challenged management's valuations where significant valuation differences arose and considered changes in investment valuations.

The combination of substantive analytical procedures and tests of detail in the audit of revenue

In the audits inspected there was effective combination of the use of tests of detail and substantive analytical review procedures in the audit of rental income.

The quality of substantive audit evidence obtained

Good practice identified included the quality of substantive audit evidence obtained to support management valuations of material investments identified as a significant risk.

Developments in the year

The firm has established a comprehensive root cause analysis process that enables them to identify why issues arose and to focus on the appropriate actions to address them. The firm also performs root cause analysis where high quality audit work is identified through external and internal reviews and circulates their findings within the audit practice.

In our previous annual reports, we have highlighted shortcomings in the firm's use of substantive analytical procedures when auditing revenue. We have seen improved audit work over revenue this year, following training which the firm provided on this area in 2016.

Audit Quality Review

FRC Audit and Actuarial Regulation Division

June 2018

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