



Financial Reporting Council

BDO LLP

AUDIT QUALITY INSPECTION

JULY 2020

The FRC

Our purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.

transparency



We have responsibility for the public oversight of statutory auditors.

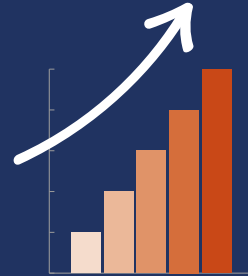
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



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
+3.65%	0.14%	+2.42%	-17.67%	POS	-4.2421
+3.38%	0.27%	+2.19%	-18.32%	NEG	-4.2083
+3.01%	0.23%	+2.28%	-14.73%	NEG	-3.5708
+3.92%	0.26%	+2.76%	-20.12%	NEG	-2.8339



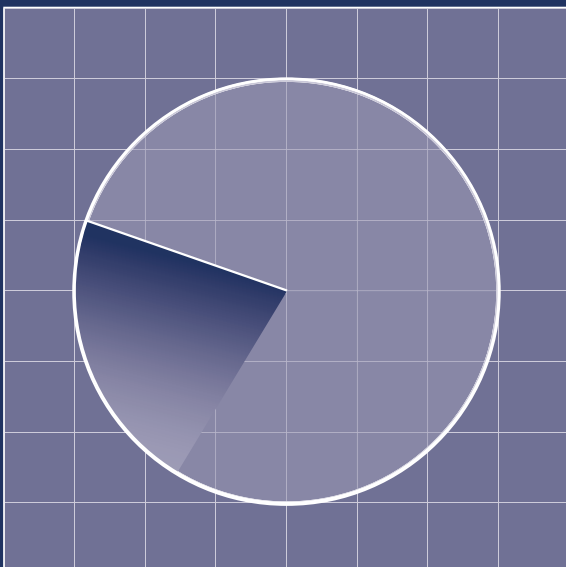
We promote continuous improvement in audit quality.

Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



The Firm

BDO LLP has 186 audits within the scope of AQR inspection, including 7 FTSE 350 audits.



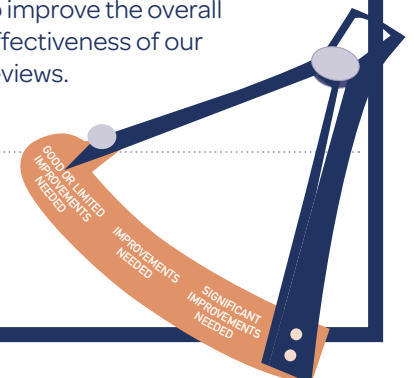
Our inspection process

There are around 3,000 audits within the scope of AQR inspection. Of these, we inspected 130 audits in 2019/20, including the 8 BDO audits covered by this report.



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

We assess the overall quality of the audit work inspected.



Financial Reporting Council

BDO LLP

Audit Quality Inspection

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.

We consider whether action under the FRC's enforcement procedures is appropriate for all reviews assessed as requiring improvements or significant improvements. In practice, audits assessed as requiring significant improvement, and some of those assessed as requiring improvement, will be referred to the FRC's Case Examiner for consideration of further regulatory action. The Case Examiner will consider the most appropriate action, including Constructive Engagement with the audit firm or referral to the FRC's Conduct Committee for consideration of whether to launch a full investigation. This may result in a sanction being imposed and enforced against a statutory auditor and/or the audit firm in accordance with the FRC Audit Enforcement Procedure.

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This report sets out the principal findings arising from the 2019/20 inspection of BDO LLP, BDO LLP Limited and BDO Services Limited ("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 March 2019 to March 2020 ("the time of our inspection"). We inspect BDO, and report publicly on our findings, annually.

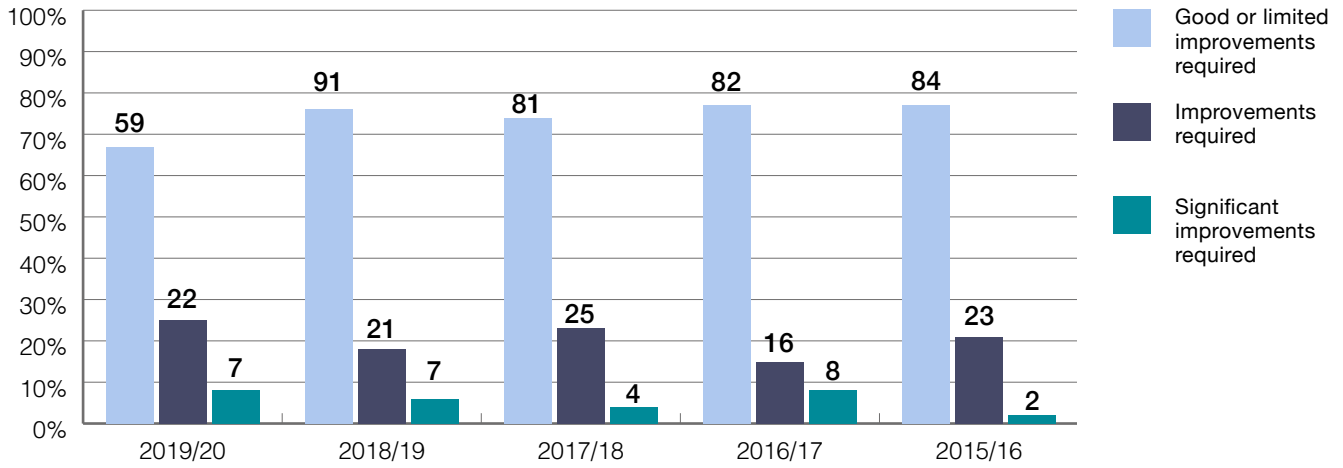
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality.

High quality audit is essential to maintain investor confidence by providing an independent, impartial view of a company's financial statements. Poor auditing may fail to alert management, shareholders and other stakeholders to material misstatements (including those arising from fraud) or financial control weaknesses, in those cases where management have not identified or appropriately amended them. The combination of management not meeting their responsibilities in this respect and poor auditing could potentially put businesses and jobs at risk. High quality audit matters and we will drive audit firms to implement the necessary changes to reach the required standards.

Our priority sectors for inspection in 2019/20 were Financial Services, General Retailers, Business Support Services, Construction and Materials, and Retail Property. Of the 108 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: Financial Services – 18, General Retailers – 16, Business Support Services – 6, Construction and Materials – 3, and Retail Property – 8. We also paid particular attention to the following areas of focus: going concern and the viability statement, the other information in the annual report, long-term contracts, the impairment of assets and fraud risk assessment.

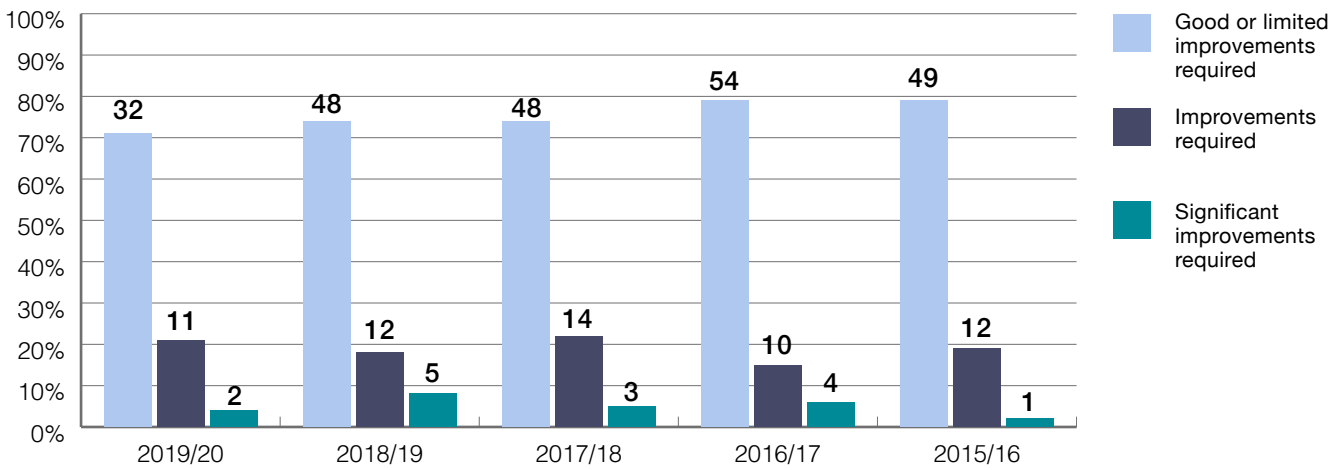
Our assessment of the quality of audits reviewed

All reviews – for the seven firms inspected annually



An audit is assessed as good or limited improvements required where we identified either no or only limited concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more issues. Significant improvements required indicate we had significant concerns, typically in relation to the sufficiency or quality of audit evidence or the appropriateness of key audit judgements.

FTSE 350 reviews – for the seven firms inspected annually



Due to resourcing constraints, we reviewed fewer audits overall than in recent years. Across all firms, we completed 130 audit inspections compared to 160 in 2018/19. We did broaden the scope of our reviews to include more aspects of the audit, including the auditor's response to fraud risk. Changes to the proportion of audits falling within each grading category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our inspections are also informed by the priority sectors and areas of focus referred to above. We are also cognisant, when making our selections, of the Competition and Market Authority's recommendation that FTSE 350 entity audits should be subject to inspection approximately every five years. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across a firm's entire audit portfolio; nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at the firm. Nonetheless, any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

1 Overview

Commentary on our inspection work at the largest audit firms

Overall, 59 (67%) of the 88 audits reviewed in our 2019/20 inspection cycle, across the seven firms inspected annually, required no more than limited improvements. The number of audits requiring more than limited improvements, 29 (33%), remains unacceptable.

Firms have made some improvements and we have observed good practices (for example, better group audit oversight and effective integration of specialists into the audit team at some firms). We acknowledge the steps taken by firms seeking to address the key findings in our 2019 public reports.

However, firms are still not consistently achieving the necessary level of audit quality. They need to make further progress. For example, we continue to find improvements needed in the same three audit areas: impairment of goodwill and intangibles; revenue and contracts; and provisions, including loan loss provisions. Over the past three years, 76 of the 166 (46%) of the findings driving reviews requiring more than limited improvements have been in these areas. These findings often relate to insufficient challenge of, and standing up to, management in areas of complexity and forward-looking judgement. Other audit areas in which we had findings for more than one firm this year include: audit of inventory, group oversight, going concern and investment property valuations.

We take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past three inspection cycles, we have referred 28 audits, across all firms inspected, for consideration of possible enforcement action.

We focused this year on key firm-wide procedures to improve audit quality, including firms' audit improvement plans and their processes to analyse the root causes of audit failings. We have raised findings in these areas to help firms build more effective quality improvement processes going forward. We will continue to focus on ensuring that the firms develop their vital root cause analysis processes to identify areas for improvement and implement change on a timely basis.

We have seen some instances of good practice where audit teams have concerns with the most significant audit judgements. Firms' senior management need to be clear that taking difficult decisions is an appropriate response to improving audit quality, even if it might sometimes mean delaying or modifying opinions, and ultimately losing some audit engagements. The tone from the top needs to support a culture of challenge and back auditors making tough decisions.

We are initiating a number of significant changes to improve audit quality, including:

- Increasing our focus on proactive supervision of the large audit firms. We will identify priority areas to improve audit quality, request the firms to implement suitable actions to achieve them and hold the firms accountable for delivery.

- Moving ahead with plans to increase the transparency of our audit quality assessments through publishing the scope and key findings of each of our individual audit inspections. We plan to publish our first set of these reports, where we have obtained the consent of the audit firm and the audited entity, next year alongside these annual reports on each of the largest audit firms.
- Asking the Big 4 firms, beginning from 2021, to implement operational separation of audit practices from the rest of the firm, so that the audit practices are focused above all else on achieving high audit quality.
- Strengthening the AQR team to increase the number of inspections in our 2020/21 cycle. We inspected a limited number of private companies and significant overseas components of groups during 2019/20, in line with the recommendations of the Kingman Review, and we will build on this as part of our overall target of 145-165 inspections for 2020/21.

We wrote to the major audit firms in December 2019¹ setting out elements that we observe consistently on high quality audits, especially on high risk engagements. The hallmarks of such audits include:

- Significant involvement of partner and other senior team members.
- Good use of specialists.
- Consultation on complex areas.
- Challenge of management leading to changes where assumptions are too optimistic.
- Robust quality control procedures.
- Clear and timely communication to Audit Committees.

We recognise the challenges posed currently by the Covid-19 pandemic, both in relation to the level of uncertainty surrounding forward estimates and projections, and inability to carry out physical procedures (for example, stocktakes). We will consider such matters carefully during our 2020/21 inspection cycle.

Audit selections

In recent years we have selected for inspection an increasing number of 'higher-risk' audits. Reliable reporting and high-quality audit matter most for these companies. This year 42 of the 108 inspections (39%), excluding public sector reviews, were higher risk compared to 32% in the previous year. We define audits as higher risk where the group or entity: is in a high-risk sector or geography; is experiencing financial difficulties; has balances with high estimation uncertainty; or where the auditor has identified governance or internal control weaknesses. Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues, for example:

- Materiality becomes a key factor in determining the significance of audit judgements for entities that have low profitability.

¹ [https://www.frc.org.uk/news/december-2019-\(1\)/letter-to-audit-firms-on-high-quality-audits](https://www.frc.org.uk/news/december-2019-(1)/letter-to-audit-firms-on-high-quality-audits)

- Headroom on impairment assessments may be lower and the entity's balance sheet may be more sensitive to changes in key assumptions.
- Going concern assessments are less clear cut.

Rigorous challenge of management and the application of professional scepticism are therefore especially important.

Perhaps because higher-risk audits are more challenging, we find that their audit quality tends to be lower. Of the audits that required more than limited improvement this year, we had identified almost half as higher risk. This year 40% (47% last year) of the audits that we identified as higher risk were assessed as requiring improvement, compared with 27% (13% last year) of audits not identified as higher risk.

Other factors that may lead both audit quality and our inspection results to vary over time include:

- The economic cycle: audit can be more difficult in an economic downturn when corporate profitability is lower.
- Changes in accounting, auditing and ethical standards: new standards can require more complex and forward-looking estimates which are more difficult to prepare and audit. Examples in recent years include forward-looking provisioning under IFRS 9 and assessing progressive revenue recognition under IFRS 15.

We have increasingly focused on higher-risk audits because they are where reliable reporting and high-quality audit matter most. Firms must perform audits to the same high standards regardless of the risks associated with the audited entity and the difficulty of the audit work.

We accept that our increased focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm. The change in our approach to audit selection over time also means that historical comparisons of results need to be treated with care.

BDO overall assessment

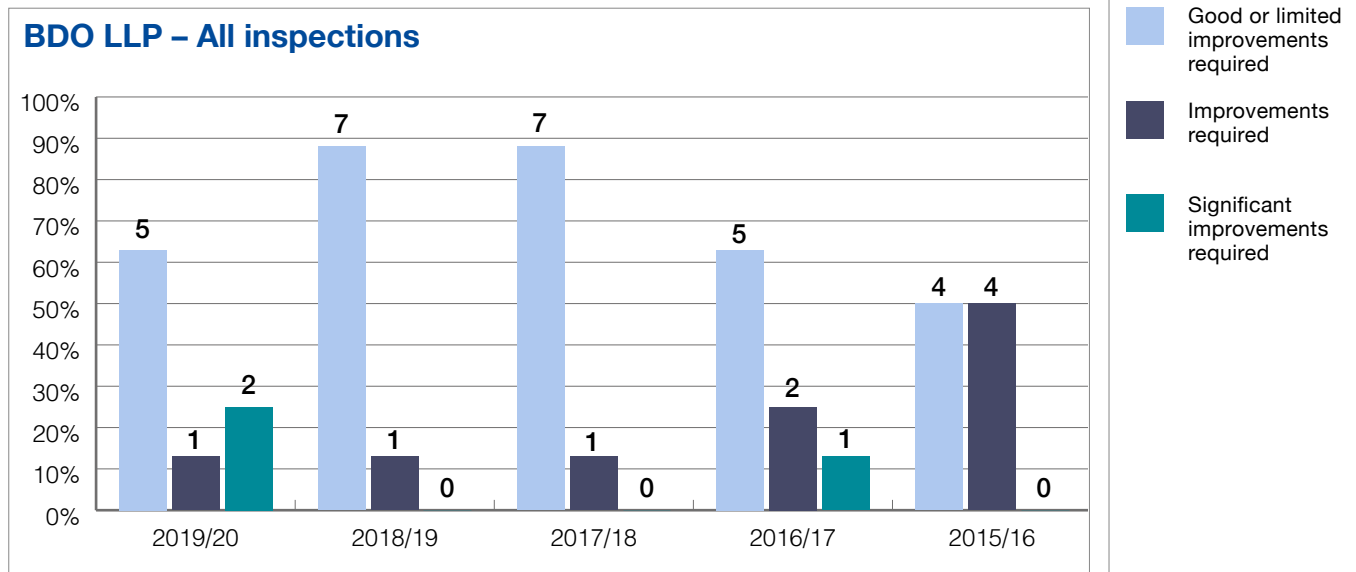
We reviewed eight individual audits this year, including a FTSE 350 audit, and assessed only 62% of them as requiring no more than limited improvements.

The firm has taken steps to address the key findings in our 2019 public report, with actions that included the introduction of standard summary schedules in key areas, with the aim of focusing the audit team's review and the introduction of a gifts and hospitality register which automatically alerts the Head of Economic Crime and the Ethics Partner and requests their review and approval. We also identified good practice in a number of areas of the audits we reviewed (including the effective use of tailored analytics) and in the firm-wide procedures (including the firm's hot review process which provides real time support to audit teams).

The findings that most contributed to the results of those reviews classified as requiring improvements were issues surrounding the audit of revenue, particularly the testing of the accuracy and occurrence of revenue and the quality of substantive analytical procedures. We note that a number of key findings identified in our reviews related to shortcomings in core auditing processes. The firm should take robust action to address our concerns.

We will closely monitor and assess the promptness and effectiveness of the firm's actions to address the findings raised. Should the firm's response not address our concerns adequately, we will take further action.

Our assessment of the quality of audits reviewed



Reviews of individual audits

Our key findings related principally to the need to:

- Improve the quality of the firm's audit of revenue.
- Strengthen the assessment of and evaluation of work performed by internal/external experts and specialists.
- Enhance the audit team's challenge in relation to the audit of estimates and provisions.

Good practice observations

We identified examples of good practice in the audits we reviewed, including the following:

- Effective use of tailored analytics.
- The extent of the group audit team's oversight and interaction with the component audit team.
- Appropriate challenge and follow up of matters raised by the auditors' internal expert.

Further details of our findings on our review of individual audits are set out in section 2, together with the firm's actions to address them, as well as details of good practices identified in those audits.

Review of firm-wide procedures

This year, our firm-wide work focused primarily on the following areas:

- Partner and staff matters relating to the FY18 performance year.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root cause analysis (RCA) process.

The reason for the focus on RCA and audit quality initiatives is the importance of ensuring that effective actions are taken to address recurring inspection findings.

Our key firm-wide findings in these areas related principally to the need to:

Partner and staff matters

- Promote staff's compliance with the firm's requirements for objective setting and appraisal completion.
- Improve the consistency of consideration and assessment of audit quality within the appraisal process including maintaining support to justify staff remuneration and the impact audit quality has on this.
- Introduce a formal and standardised assessment process for senior manager promotions.

A&C procedures

- Strengthen the acceptance and continuance approval process, in particular the evidence to record and explain the conclusions reached.

Audit quality initiatives

Our key findings are set out below:

- Clarify how the firm will take robust and appropriate actions through its audit quality plan, to reinforce the firm's commitment to a culture of both continuous improvement and enhanced audit quality.
- Further embed a culture of challenge into the audit process.
- Improve the assessment of resources.
- Enhance project management procedures, such as through a formal milestone program.

RCA process

- Expand the scope and coverage of RCA on internal inspections to involve the firm's central team in more RCA discussions.

- Enhance the consideration of the effectiveness of supervision and review as a possible root cause within the RCA process.
- Expand and vary remediation action for recurring and common findings.

Good practice observations

We identified examples of good practice in our review of firm-wide areas, including the following:

- A robust hot review process which provides real time support to audit teams.
- Timely completion of RCA on audit engagements and involvement of the whole team including the EQCR and specialists if appropriate in one interview.

Further details of our findings in these firm-wide areas are given in section 3, together with the firm's actions to address them, as well as details of the good practices identified.

Firm's internal and ICAEW quality monitoring results

This year we have included, in each of our public reports, summary results of the firm's internal inspection results, together with, where performed, those of the ICAEW's latest quality monitoring. We consider that these results provide additional relevant information in relation to the assessment of the firm's audit quality.

The results of the firm's internal inspection results are set out in Appendix 1. The firm did not receive a full ICAEW quality monitoring visit in the year and therefore no ICAEW inspection results are included in the appendix.

Results of RCA and firm's related actions

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

In section 3 we have commented on the firm's RCA processes, based on our review of them earlier in the inspection cycle. The firm has since performed RCA in respect of our current findings and considered the outcome in developing the actions included in this report. We have reviewed the results (and related processes) of this and set out our key observations below, including whether there have been improvements in the related RCA processes since our review earlier in the year:

- The firm has a lower level of coverage of centrally-led RCA reviews across internal and external inspection findings than the other firms. Particularly, the firm has a lower level of coverage of RCA reviews across good practice points. The firm does, however, require all teams to perform their own RCA on internal quality inspection findings.
- Unlike some firms the firm does not perform RCA reviews over firmwide findings.
- For some inspection findings, it was not clear how the firm had ensured that they had identified the underlying root cause.

- The firm does not have a formal process for identifying and evaluating common causal factors arising from the firm's internal and external RCA.
- The actions set out in the firm's RCA report are not as wide ranging as those of other firms. In respect of challenge of management and the effectiveness of partner and manager reviews the actions should be enhanced. Some of the firm's other actions as detailed in their RCA report were not yet fully developed.

We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques further.

Firm's overall response and actions:

We are disappointed to see a fall in the profile of our results this year. We remain committed to continuous improvements in audit quality and see root cause analysis as a key focus in achieving this as is detailed in our Audit Quality Plan which is the responsibility of the Audit Stream Executive (ASE). In light of the AQR findings, we will be enhancing our audit quality plan to ensure that there is clear linkage between the actions we take as a firm to improve quality and the firm's overall results.

We are intending to make a number of enhancements to this process as follows:

- We are considering the increased resource needed in order to expand our involvement in relation to RCAs on internal inspection findings and to enable involvement on all external file reviews regardless of grade achieved.
- We will continue to perform RCA on Firmwide findings where we consider the involvement essential to implement a successful suite of actions to address the issue.
- We will enhance our documentation trail of root cause analysis investigations with particular focus on the assessment of common causal factors across different investigations.
- We are in the process of finalising our internal RCA investigations for the current period of external and internal inspections and we will update the actions to be undertaken in our Audit Quality Plan to be presented to the Audit Stream Executive for consideration.

As part of our monitoring of audit quality, we performed root cause analysis on the findings raised by the AQR and considered a number of common factors:

- We identified in a small number of engagements that the audit team needed to be better at fully articulating the full flow of the revenue streams. As a consequence we have reinforced the importance of audit teams developing their own diagrammatic representation of the systems, as opposed to relying on those produced by the audited entity and that they are able to explain this in plain English to the central review teams, as it is considered that this will enhance the team's understanding.

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- In a small number of engagements, we identified that the RI should have documented more clearly their involvement in both the setting and execution of the audit strategy.
 - We identified examples where the RIs thought processes, considerations and judgements, were not being coherently captured and we have therefore introduced a summary memorandum which in a concise way articulates all aspects of the RIs considerations in arriving at conclusions in significant areas. The memorandum also captures the EQCR's conclusions on the relevant matter.
 - In some cases where audit teams did not consult fully within their sector to ensure that sector knowledge and expertise in relation to best practice for testing strategies and pro forma documentation was taken advantage of there were issues with the approach taken by the team.
 - One team that achieved good practice points split the responsibility of project manager quality control of the audit file between two senior members of the team, introducing an objective quality review of the file into the live audit process by someone with a deep understanding of the client. We have encouraged teams to look at the split of responsibilities within the team to ensure that one senior member of the team focuses on the quality control aspects.
 - Interaction with experts and specialists was subject to both good practice points and findings by the AQR indicating that the approaches undertaken by teams within the firm are inconsistent. Already we have undertaken a number of root cause analysis investigations, working with both audit teams achieving good practice points and audit teams where issues were raised in relation to their approach. We intend to undertake a number of actions in this area including enhancing our current standard documentation and using case studies in our summer training programme. We are working closely with our IT audit specialists to emulate good practice working relationships highlighted by the AQR during this review period.
 - In order to enhance the abilities of the audit teams to apply challenge of management in a practical sense, the firm will also be implementing a new professional judgement framework, which will be in place for December 2020 year ends. This will provide a shared conceptual foundation and common vocabulary for use by the audit teams and aid evaluating and challenging complex issues and ensuring they are properly documented and clearly communicated.

We will monitor closely the promptness and effectiveness of the firm's actions. Should these not address our concerns adequately, we will consider appropriate action.

2 Review of individual audits

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

Improve the quality of the firm's audit of revenue

Last year we reported that the firm needed to strengthen audit procedures relating to the timing of revenue recognition. This is a key issue as revenue is an important driver of operating results for many entities. It is often identified as a key performance indicator on which investors and other users of financial statements focus. Accounting for revenue recognition may be susceptible to manipulation, particularly where entities perform significant amounts of variable work. Audit teams should design an approach which is responsive to the identified risk and obtain sufficient and appropriate audit evidence to support the revenue recognised.

Key findings

We reviewed the audit of revenue on the majority of audits we inspected and continued to identify issues with the audit of revenue on one or more of these audits:

- The audit approach adopted did not provide sufficient assurance over the accuracy and occurrence of revenue recognised. In particular, in one case, the audit team did not consider the implication of weaknesses arising from IT work and any related impact on the integrity of data. Furthermore, the audit team did not assess and evaluate other work performed outside of the statutory audit. This work was needed to confirm the value of trades and support the revenue recognised.
- Substantive analytical review constituted the main substantive procedure for certain income streams on some audits we reviewed. In two cases we identified examples where the substantive analytical review procedures performed were inadequate as the audit team's expectation was not independent. On one of these audits, where revenue was identified as a significant risk, there was also insufficient follow-up and corroboration of the variances identified between the expectations set and the actual results.
- On one of these audits, insufficient audit procedures were performed to corroborate the completeness of revenue derived from a system maintained and operated by a third party.

The issues outlined above cover a broad spectrum of work on revenue, focusing on the risks arising in respect of accuracy and occurrence. The firm should take prompt action to reassess the breadth and depth of their root cause analysis in relation to revenue, ensuring that its actions are properly embedded in enhanced audit procedures. This should be followed up and monitored through the firm's audit quality plan using the hot review monitoring process.

Firm's actions:

As noted above, we have undertaken detailed root cause analysis in order to address the issues raised in relation to revenue as we acknowledge the importance of the revenue strategy in relation to audit quality.

We have undertaken the following actions:

- Implemented a requirement for all audit teams working on public interest entities to have a consultation on the audited entities' revenue system process with members of the central audit support team before the audit strategy is created. This will include the creation of a systems diagram by the team which details all related IT systems. The aim is to achieve an improved audit strategy that considers clearly the initiation of revenue and how best to test it. It also considers the point of revenue recognition and how to test this sufficiently to ensure occurrence of revenue is properly considered.
- Introduced a summary memorandum which in a concise way articulates all aspects of the RIs considerations in arriving at conclusions in significant areas.
- Reminded audit teams to use the Substantive Analytical Procedures (SAPs) guidance and proforma documentation to ensure SAPs are only used where they will be most effective and sufficiently precise expectations can be set. This has been monitored by our internal quality review processes alongside the findings from external reviews over the last few years since it was implemented and we have seen improvements in this area so it is key that audit teams continue to ensure it is used and followed.

Strengthen the assessment of and evaluation of work performed by internal/external experts and specialists

Audit teams often use the firm's specialists (working as part of the audit team) or experts (reporting to the audit team) in technical areas or those requiring estimation or judgement. Management often engage external experts in similar areas, to provide independent valuations. Audit teams should assess and evaluate the objectivity and capability of the specialist/expert and determine if the conclusions and outcome of their work addresses the risks identified.

Audit teams engaged internal specialists/experts or management of the audited entity engaged experts on most audits we reviewed in areas such as IT, insurance provisions, property valuations and financial investments.

Key findings

We identified issues regarding the assessment and evaluation of the work performed by internal specialists/experts and experts engaged by management. In particular:

- In half of the audits we reviewed, audit teams did not sufficiently assess the relevance and reasonableness of certain inputs and/or assumptions used by management's experts to support the valuation of various judgemental balances in the financial statements.

- In two cases, the audit team did not consider the objectivity of management's expert to value various assets and liabilities in the financial statements. In one of these instances, the experts had been engaged by management for 20 years.
- Audit teams failed to demonstrate sufficient scepticism when challenging management's experts in three of the audits we reviewed.
- On two of the audits we reviewed, the audit team engaged internal specialists to address the identified significant risk and provide additional assurance over the balance. The audit teams did not sufficiently integrate the specialists in the audit team and did not adequately follow up on matters raised and weaknesses identified.

There was clear evidence that the firm's current template was being completed inconsistently by audit teams. The programme and guidance did not therefore ensure that all audit teams addressed the requirements of Auditing Standards in this area.

In two instances interaction with and evaluation of the work performed by the specialist/expert enhanced the audit procedures performed. The firm should therefore assess the inconsistency in the way teams evaluate and interact with specialists, including an assessment of the current work programme and methodology.

Firm's actions:

Use of experts continues to increase as audits become more complex and we need to involve these individuals/teams in our audits. We note the AQR's comment that there are some good examples of audit teams interacting with audit experts and specialists and as noted above we are using RCA to enable us to emulate this good practice across all audit engagements.

Initial considerations:

- The importance of the integration of the TRA specialist as a member of the audit team and the working relationship throughout the audit.
- We have held a number of initiatives during the year such as a week long course for digital audit champions in all offices to increase the level of knowledge of IT audit for the general auditor.
- As noted above for the documentation that supports the use of both management and auditor's experts we need to give further consideration to the way this can be evidenced in the firm's system given there are aspects that need to be addressed at both the planning and execution phases. This is a longer term project and in the shorter term we will consider if we can enhance the existing standard work programme to drive more consistent usage.
- As part of the summer training programme we will use case studies to enable audit teams to understand the good practice points raised by the AQR in this area.
- We will make use of the professional judgement framework that we will be introducing to assist with ensuring that assumptions are appropriately identified, challenged and findings therefrom clearly evaluated.

Enhance the audit team's challenge in relation to the audit of estimates and provisions

Estimates and provisions in financial statements are inherently subjective and can be both susceptible to management bias and sensitive to changes in key assumptions. Audit teams should apply an appropriate level of challenge, adequately test the assumptions applied and obtain sufficient audit evidence to evaluate and support the significant judgements made.

Key findings

We raised findings relating to the evidence of appropriate consideration or challenge of certain estimates and provisions including those arising on long-term contracts and insurance technical liability provisions:

- Inadequate assessment of the stage of completion on individual contracts and the appropriateness of revenue recognised.
- In relation to estimated future costs on loss-making contracts, inadequate testing and evidence of challenge of management's estimate of future costs and whether additional provisions were required.
- Insufficient evaluation of the validity and appropriateness of amounts claimed and recognised as revenue from contract variations not formally agreed with the client.
- On two audits reviewed, the audit teams did not sufficiently evaluate, challenge and corroborate management's claim estimates.

Firm's actions:

As noted above in relation to the audit of revenue, we have introduced a central consultation on the revenue system which incorporates consideration of the revenue accounting policy as well as summary memorandum which in a concise way articulates all aspects of the RIs considerations in arriving at conclusions in significant areas. We consider that this will assist with the issues noted in relation to the point of revenue recognition.

The audit of estimates and provisions will be a key focus for the firm over the forthcoming year. We are implementing a new professional judgement framework which will be supplemented by training, the adoption of which will be monitored through thematic reviews.

Good practice

We identified examples of good practice in the audits we reviewed, including the following:

- **Effective use of tailored analytics:** On one audit the audit team enhanced the quality of its work and demonstrated a clear and thorough knowledge of the entity by tailoring the firm's data analytic tool for journals testing. This resulted in a detailed and comprehensive review of journals and was supported by appropriate corroboration and follow-up.
- **The extent of the group audit team's oversight and interaction with the component audit team:** We identified an example of good group audit team direction, supervision and review of the work of an overseas component team. This included significant interaction with the component team in respect of significant risk areas and a robust review of the component team's working papers.
- **Appropriate challenge and follow up of matters raised by the auditors' internal expert:** As noted above we identified instances, in two audits, where the audit teams' interaction with and evaluation of the work performed by the specialist/expert enhanced the audit procedures performed. As this area has equally been identified as a key finding the firm should address the inconsistency and use these examples of good practice to assist in their remediation.

3 Review of firm-wide procedures

We reviewed the firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 (“ISQC1”), as well as certain other key audit initiatives. We review some areas on an annual basis, and others on a three-year rotational basis. This year, our firm-wide work primarily focused on the following areas:

- Partner and staff matters relating to the FY18 performance year.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root cause analysis (RCA) process.

Partner and staff matters

Background

Processes relating to the appraisal and remuneration of partners and staff are a key element of a firm’s overall system of quality control and are integral to supporting and appropriately incentivising audit quality. Our inspection included an evaluation of the firm’s policies and procedures, and their application to a sample of partners and staff for the 2018 appraisal year, across the following areas: appraisals and remuneration; promotions; recruitment; and portfolio and resource management.

Key findings

We identified the following key findings:

- Enhance staff’s compliance with the firm’s requirements for objective setting and appraisal completion: As of March 2019, only 40% of staff had appropriately completed their FY18 appraisal in the firm’s performance management system, and only 75% had set objectives for FY19.
- Improve the consideration and assessment of audit quality within the appraisal process, including support to justify staff remuneration and the impact of audit quality: Across the sample of individual appraisals reviewed, there was a lack of consistency in the level of consideration given to audit quality, with several instances where there was only limited evidence of these considerations.

The firm does not operate a staff bonus scheme. Annual salary increases are based on appraisal performance. However, across the AQR’s sample, there was insufficient evidence to demonstrate the basis for remuneration decisions or how these had been influenced by the assessment of audit quality.

In addition, we identified concerns around the lack of a formal process to ensure that relevant quality metrics (including the results of internal or external inspections) were considered and appropriately reflected in senior staff appraisals and objective setting.

- Introduce a formal and standardised assessment process for senior manager promotions: The firm does not have a formal assessment process in place for senior manager promotions so that audit quality is appropriately and consistently considered for all promotion candidates. For two senior manager promotions sampled, there was no evidence of how audit quality had been considered.

Firm's response and actions:

A number of actions have been undertaken already in this area:

- A deadline was set by which all objectives were required to be entered in to the firm's performance review system for the FY19/20 appraisal year. All objectives had been submitted by the end of December 2019.
- In relation to the FY19/20 appraisal year, we communicated with all Partners/Directors who had a counselee who received an adverse quality rating to ensure there was a clear link between these findings and the subsequent pay review.
- A standard document has been introduced to ensure that all elements of the discussions held in relation to promotions include considerations of audit quality. These documents are required to be approved by the Local Heads of Audit to confirm they capture all salient points.
- The firm is currently conducting a review of all of its promotion milestones and this will include the Senior Manager promotion process to consider how to implement a more formal process.

Acceptance and Continuance (A&C) procedures

Background

Audit quality control processes incorporate risk management procedures and are undertaken at various stages of the engagement. In accordance with the requirements of ISQC1, the firm has detailed policies and procedures relating to acceptance and continuance decisions for audited entities. We have reviewed these processes and their application within our firm-wide inspection activity this year.

Given the greater number of audit tenders in recent years, we assessed firms' acceptance and continuance processes as at October 2019. We also discussed with senior leadership any proposed changes to these processes together with each firm's strategic decisions. In addition, we considered firms' policies relating to withdrawal/dismissal from audits and, for a sample of audits, the statements provided to the public, successor auditors and the regulatory authority in connection with withdrawal/dismissal.

Key findings

We identified the following key findings:

- The firm should strengthen the acceptance and continuance approval process, in particular the evidence to record and explain the conclusions reached. The firm's acceptance and continuance form is based on a choice of set responses, often without supporting narrative (for example, to explain why previous risk factors are no longer relevant, why it is appropriate to continue acting for the client and how it aligns with the firm's overall strategy). It also does not give sufficient prominence to the assessment of the potential impact on the firm's brand and reputation risk or the availability of appropriate resources, including specialists, required by the firm to undertake the engagement.

Firm's response and actions:

The firm implemented a new client take on system last year and a number of changes will be made going forward to ensure this process is efficient and effective for all new engagements taken on by the firm.

The audit stream is implementing their own additional process which will be used for acceptance and continuance of all engagements and used as a replacement for the current forms included within the firm's audit tool.

At present all new audits that are undertaken in the public interest market or that will require a substantial investment in resource from the firm require approval by the Audit Stream Executive to ensure issues such as reputation, resourcing and risk are considered. The accompanying documentation considers fully the consideration and conclusions for all these matters. The procedures detailed above will ensure this is the case for all engagements going forward.

The ASE will review the PIE client list on an annual basis for any that exhibit an unacceptable level of risk.

Audit quality initiatives

Background

We reviewed key aspects of the firm's management system to maintain and monitor audit quality ("the plan"). This included details of the firm's audit quality targets, the firm's responsibility in relation to audit quality and the tools in place to ensure that quality is improved. BDO's audit quality plan was approved by the Audit Stream Executive (ASE) in January 2020.

The plan has been devised as a working document, formalising and linking various quality initiatives which the firm has been using for several years, including hot reviews, consultation and root cause analysis. The ASE intends to monitor action plans supporting the quality plan on a monthly basis and update the quality plan on a quarterly basis. The

plan focuses on an integrated approach to quality, linking risk assessment to monitoring and remediation. It covers firm governance and leadership, ensuring that audit quality remains at the forefront of the firm's agenda, embedding a culture of consultation and real-time support and undertaking a regular review of resources to ensure that these are appropriate in terms of level and competence.

Given the nature of the findings arising, the firm should take prompt and specific action using the audit quality plan and both strengthening and enhancing this to address the concerns raised, achieving greater consistency in audit quality across the firm.

Key findings

Our key findings are set out below:

- Clarify how the firm will take robust and appropriate actions through its audit quality plan, to reinforce the firm's commitment to a culture of both continuous improvement and enhanced audit quality. The firm should develop a clearer cohesive framework that provides transparency and traceability between its quality control processes and key performance indicators (KPIs). This will help both effective monitoring of problems identified, KPIs and any required timely remediation.
- Further embed a culture of challenge into the audit process: It was unclear how the plan will embed a culture of challenge into the audit process. Challenge is incorporated in the firm's "mindset quadrant" of its audit quality cornerstones but the firm should clarify what this means in terms of values and expected behaviours of audit teams and how change will be facilitated.
- Improve the assessment of resources: Whilst the plan recognises the need for competent, capable staff at all levels, detailed resource planning and central oversight of this for the audit stream was insufficient. The firm should evaluate available resources on a real-time basis and consider the impact that this has on audit quality and the firm's ability to meet its overall objectives.
- Enhance project management procedures, such as through a formal milestone program: Some firms have formal milestone programs with clear targets for when key phases of the audit should be completed. The plan does not consider project management for individual audits and how this can improve quality.

Good practice

We identified the following area of good practice:

- **Hot review process:** The firm has various hot review processes which provide real-time support to audit teams to improve audit quality prior to issuing the audit report. Hot reviews should enhance the quality of the audit and ultimately the opinion issued.

Firm's actions:

As noted in this report, although we brought our audit quality plan together as one document in January 2020 we have been undertaking many of these initiatives for a number of years. The Audit Stream Executive considers the inputs and outputs supporting the plan on a quarterly basis where the whole meeting is devoted to audit quality improvement and agreeing any required changes to the plan or actions going forward.

More recently the ability for the plan to be flexed to meet current situations has been demonstrated in the approach to dealing with the Covid-19 situation.

In relation to the specific points raised:

- We will use the observations from the AQR to make some enhancements to the linkages within our audit quality plan to specifically detail how the various policies and procedures will work together to achieve our key targets and give clarity of how actions undertaken will support short term objectives which support our key targets in the long term. We will also ensure it highlights the key responsibilities of the central quality steering committee in monitoring all inputs and outputs to the plan and how these are then further monitored and actioned by the Audit Stream Executive.
- As noted above, challenge of management is one of the quadrants of our audit quality cornerstones which details the application of a fundamental part of the firm's strategic framework 'Committed to quality, independence and ethics' to the audit stream. In the light of some of the findings in this report, additional actions are needed to further embed this mindset into the audit teams, which is a key focus of the Audit Stream Executive, and will be assisted by the implementation of a new professional judgement framework.
- The national Head of Audit reviews utilisation statistics on a weekly basis and revenues per professional member of staff on a monthly basis. On a quarterly basis there is a discussion with the Local Heads of Audit on forthcoming demands on resources, utilisation and any staff member who looks to have high levels of chargeable hours.
- Part of the firm's plans for Audit Quality Indicators (AQIs) will involve the use of project milestones extracted from the firm's audit tool and considered during audit engagements to allow interventions where situations arise that look to potentially compromise audit quality such as the timely approval of planning by the partner. In relation to project management, we are adopting an approach to strengthening the project management on our audit engagements which will be rolled out by the end of September 2020.

The Firm's RCA process

Background

The RCA process should be designed to identify the causes of inspection findings, in order to aim to prevent them from recurring. It is part of a continuous improvement cycle of inspecting audits, investigating the root causes for inspection results and improving the firms' ability to act on them through implementing effective actions.

The firm has been performing RCA for a number of years and has designed a process in conjunction with an external provider.

This year, we have reviewed the firm's process for undertaking its RCA, including resources and timing. We note that whilst the firm's RCA process has been in place for a number of years it is still evolving and will continue to do so. BDO perform RCA on certain individual inspected audits and thematic RCA driven by specific findings that have been identified on a number of inspected audits. The firm does not necessarily perform centrally-led RCA on all internally and externally inspected audits but instead considers whether the findings warrant a detailed RCA (for example, when a pattern of findings suggests that a firm-wide action might be identified). In some cases, the audit team meets to discuss the causes of audit findings and in others these meetings are facilitated by a central team. In contrast to some firms, behavioural specialists are currently not used as part of the RCA process.

The firm's RCA work should be further developed and enhanced as outlined below to ensure that the audit quality plan includes responsive actions to achieve an improvement in audit quality.

Key findings

The firm should further improve the RCA process, in particular by:

- Expanding the scope and coverage of centrally-led RCA on internal inspections to ensure consistency, improve the quality of the causes identified and the firm's resulting actions.
- Enhancing the investigation of the effectiveness of supervision and review for both positive and negative inspections, to determine whether this was a causal factor of the outcome of the review.
- Expand and vary the suite of remediation action for recurring and common findings to ensure that any action taken is effective in addressing the issue identified.

Good practice

The firm has continued to develop its RCA process. We identified the following examples of good practice in the RCA process:

- **Timing of reviews:** The firm sets deadlines for completion of RCA on individual audits. This ensures that the RCA is performed on a timely basis.
- **Involvement of the whole team:** RCA investigations involve staff of all levels and, if appropriate, include specialists and the engagement quality control review partner in one interview session.

Firm's response and actions:

As noted we continue to enhance and develop our RCA process as we firmly believe that, if done properly, it is a key tool in enhancing audit quality. As a firm we believe there is not a one size fits all approach to RCA and therefore our approach to RCA is tailored to perform RCA in the areas where we consider it will make a difference. We will also continue to use a mixture of individual discussions and group sessions as part of our RCA investigations as we believe they work well as a combination to draw out issues.

We plan to make a number of changes to the process in the future:

- We have plans to expand the use of RCA in the future and are considering increasing the resource available to facilitate this.
- We plan to perform RCA on all AQR and PCAOB findings regardless of grade achieved. At present we only perform RCA on grade 2A files where good practice has been identified or there are similar issues to those identified elsewhere.
- We will review the current RCA process for internal investigations to identify where central team involvement would be most beneficial as well as those that receive a grade 3 which is the current policy. We will consider the central oversight of all other investigations to ensure that any common issues are considered and feed into the firm's action plans.
- Supervision and review is considered in the light of findings on all RCA discussions. However, we will enhance this aspect of our investigations.
- We will continue to create actions that we believe will best address the issues arising. The ongoing monitoring of our Audit Quality Plan will enable us to consider progress against specific actions and adapt these further where necessary.

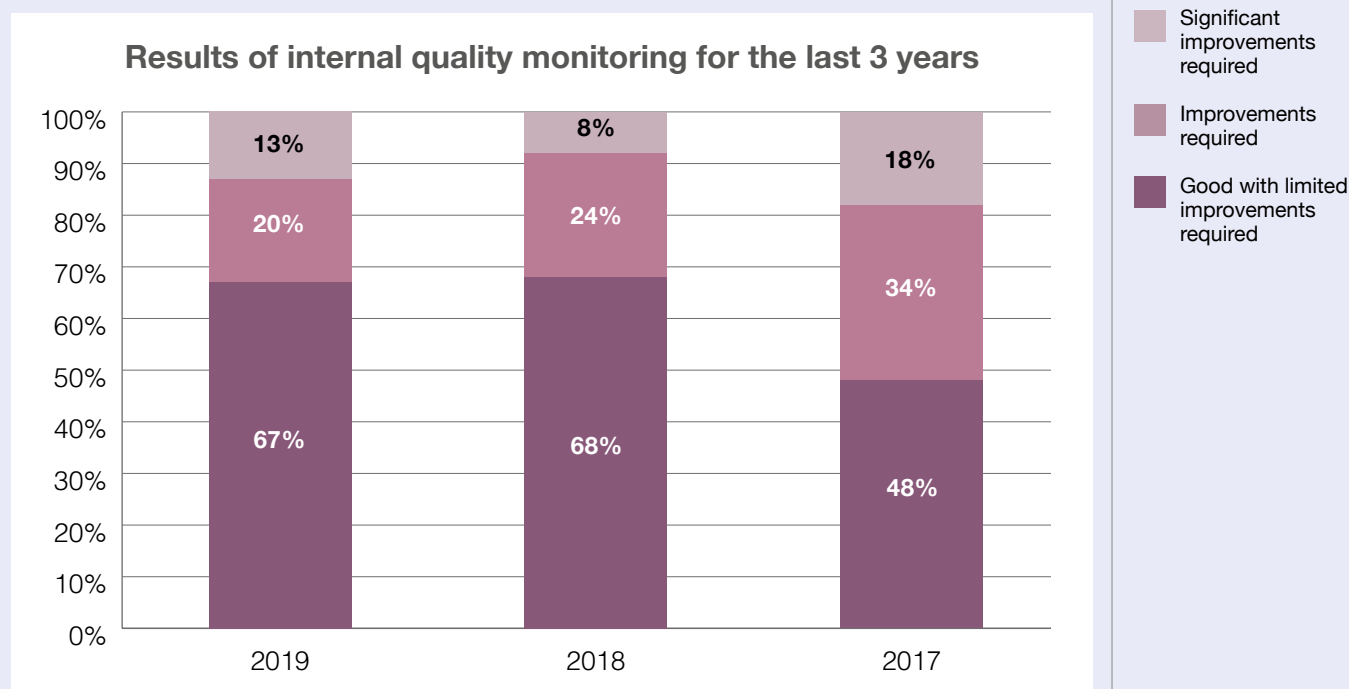
Appendix 1: Firm’s internal quality monitoring

This appendix sets out information relating to the firm’s internal quality monitoring for individual audit engagements. It should be read in conjunction with the firm’s transparency report for 2019 and the firm’s report to be published in 2020, which provide further detail of the firm’s internal quality monitoring approach and results and its wider system of quality control. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

Due to differences in how inspections are performed and rated, the results of the firm’s internal quality monitoring may differ from those of external regulatory inspections and should not be treated as being directly comparable to the results of other firms.

Results of internal quality monitoring

The results of the firm’s most recent Audit Quality Assurance Review (“AQAR”), which comprised internal inspections of 81 individual audits with periods ending between 31 December 2017 and 31 March 2019, are set out below along with the results for the previous two years.



The grading categories used in the graph above are as follows:

- **Significant improvements required:** Audits are graded 3 where the audit procedures planned or audit evidence obtained did not provide reasonable assurance that no undetected material misstatements, individually or collectively, in the financial statements were present; or there are significant concerns in relation to the appropriateness of one or more significant audit judgements.
- **Improvements required:** Generally, an audit is graded 2 where there are either a number of key findings relating to weaknesses in the audit evidence obtained or where there are some concerns in relation to the appropriateness of one or more significant audit judgements, the impact of which is unlikely to be material.
- **Good with limited improvements required:** This grade covers audits which are of a good or acceptable standard. Any key findings should be limited both in significance and in number.

Firm's approach to internal quality monitoring

The firm's internal inspection program considers the full population of audits performed.

The AQAR is designed to cover each Responsible Individual ("RI") at least once every two years, and to ensure that an average of 60% of RIs are reviewed in any one year. The sample of audits selected for review is weighted to ensure that an appropriate number of public interest entities are included. The AQAR reviews of AQR-scope audits are designed around the AQR focus areas, are completed by the firm's central AQAR team and are overseen by the AQAR partner. Non-AQR-scope audits are peer reviewed by individuals in the audit stream under the guidance of a review team leader (an audit partner) and are moderated by the AQAR partner.

The firm undertakes Root Cause Analysis ("RCA") for all audits receiving a grade 3. The firm does not perform RCA on positive findings such as for audits graded 1 as this is the expected standard for all AQAR reviews. All RCAs are undertaken by a central team. The results of the RCA consider both actions for the audit team itself at an audit level and any actions for the audit stream as a whole.

Firm's response and actions:

The AQAR reviews included 13 AQR-scope audits of which the proportion graded as good has increased substantially from the prior year (2019: 83% compared to 2018: 42%). One of the AQAR reviewed audits graded 3 was AQR-scope. Given the relatively small population of audits reviewed by both the AQAR and the AQR it is difficult to make direct comparisons between the internal and external results.

RCAs for the 2019 AQAR review are in the process of being completed. Initial findings at this stage include:

- RIs must remain alert to the need to re-challenge previous audit decisions and audit approaches to ensure they are still appropriate for the circumstances of the engagement, including when they rotate onto an engagement.
- When audit teams are confronted with transactions which occur infrequently they need to ensure that they re-refresh their understanding of the relevant financial reporting requirements.
- Audit teams need to appreciate the importance of the final analytical review as a 'stand back' procedure to ensure that the financial statements are consistent with their broader knowledge of business activity in the year.

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