Public Report

Financial Reporting Council

March 2013

Grant Thornton UK LLP

Audit Quality Inspection

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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 Grant Thornton UK LLP ("Grant Thornton" or "the firm") carried out by the Audit Quality Review Team of the Financial Reporting Council ("the FRC"). We inspect Grant Thornton approximately every two years; our previous inspection report was published on 26 July 2011. Our current inspection was conducted in the period from February 2012 to September 2012 (referred to as "the time of our inspection"). The objectives of our work are set out in Appendix A.

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

We reviewed ten audit engagements undertaken by the firm. These related to FTSE 250, other listed and other major public interest entities, with financial year ends between March 2011 and March 2012. 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 this report, these were: group audit considerations; the valuation of assets held at fair value; the impairment of goodwill and other intangible assets; the recoverability of deferred tax assets; the assessment of going concern; revenue recognition; related party relationships and transactions; and the quality of reporting to Audit Committees.

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

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

Tone at the top and internal communications

Transparency report

Independence and ethics

Performance evaluation and other human resource matters

Audit methodology, training and guidance

Client risk assessment and acceptance/continuance

Consultation and review

Audit quality monitoring

Other firm-wide matters

We exercise judgment in determining those findings which it is appropriate to include in our 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 our 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.

We acknowledge the co-operation and assistance received from the partners and staff of Grant Thornton in the conduct of this inspection.

1.2. Background information on the firm

Grant Thornton UK LLP is a limited liability partnership with 26 offices. It is a member of Grant Thornton International, a global network of firms using common audit methodology and audit software. The firm is a unitary partnership and as such there are no non-equity partners.

For the year ended 30 June 2012, the firm's turnover was £417 million, of which £120 million related to Audit. There were a total of 206 partners, of whom 68 were authorised to sign audit reports, and 32 employees (audit directors) who were also authorised to sign audit reports[1].

We estimate that the firm audited 188 UK entities within the scope of independent inspection as at 29 February 2012. Of these entities our records show that 75 had securities listed on the main market of the London Stock Exchange, including five FTSE 250 companies.

Audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area are subject to inspection under arrangements which we have agreed with the relevant regulatory bodies. The firm and relevant bodies have informed us that the firm is not registered to conduct audit work in any of these jurisdictions and has no such audits.

[1] As disclosed in the annual return to the ICAEW as at 31 December 2011.

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 previous inspection.

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

Our file review findings, as set out in section 2, largely relate to the application of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits. The findings arising from our file reviews were diverse and lacking in common themes.

1.4. Key messages

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

- Ensure that the firm's strategy to target growth does not have an adverse impact on audit quality in practice.

- Enhancing centralised monitoring and control of certain firm-wide processes, for example in relation to overdue fees and potential litigation, together with the ethical implications thereof, would facilitate better understanding of the potential issues at individual offices and reduce the risk of undetected breaches of Ethical Standards.

- Increase the robustness of the reporting of findings from internal annual quality reviews and the timeliness of the overall report.

- The number of issues identified by internal and external quality reviews remains high and the firm should strengthen quality control procedures further to address this.

- Take further action to ensure that greater professional scepticism is exercised on individual audits.

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. Reviews of individual audits

Follow-up of audits reviewed in the previous inspection

We undertook one follow-up review of an audit we had reviewed in the previous inspection. The issues we raised had been satisfactorily addressed, resulting in improvements to audit quality in the relevant areas.

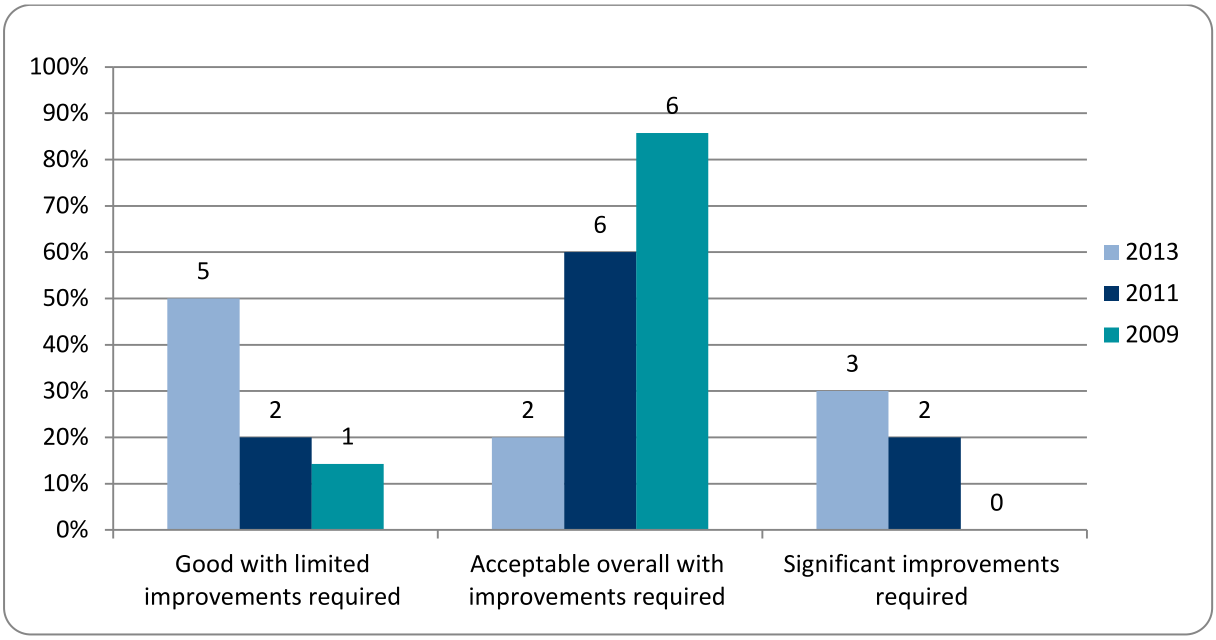
Audits reviewed during the current inspection

We reviewed and assessed the quality of selected aspects of ten (2011: ten) audits.

In our view, five of the audits we reviewed (2011: two) were performed to a good standard with limited improvements required and two audits (2011: six) were performed to an acceptable overall standard with improvements required. Three audits (2011: two) required significant improvement in relation to the sufficiency of audit evidence obtained in key areas; one in respect of financial assets and intangibles; another in respect of the carrying value of fixed assets; and another in respect of loss of audit work papers, in particular relating to property valuations and the related quality control procedures.

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

The bar chart below shows the percentage of the audits we reviewed in the current inspection falling within each grade with comparatives for our two previous inspections.



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

Findings in relation to audit evidence and judgments

Our reviews focused on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk. We draw attention to the findings below which the firm should ensure are addressed appropriately in future audits. The implications of such findings for our overall assessment of an audit depend on their significance in the context of the audit.

Professional scepticism

On six audits we identified concerns regarding the level of professional scepticism applied in key audit areas as follows:

On one audit, the formal contract for a significant project was finalised around the year end date. The high level of income and significant profit recognised from this contract, together with the fact that the final signature from the customer was only obtained after the year end, should have resulted in a greater degree of professional scepticism being applied by the audit team. Issues requiring more explanation and challenge were the treatment of an option to extend the contract period and the pricing, especially the treatment of a discount given.

In another audit, in relation to additions to intangible assets, there was insufficient consideration and challenge of the appropriateness of additional payments being treated as capital additions to client relationships, given the requirements of the Accounting Standards.

On two further audits, the current economic environment, in particular the impact of public spending reviews, was not specifically considered and addressed, in relation to work on going concern. On one of these audits there was evidence on file of other risks associated with going concern that had not been explicitly addressed.

On another audit, despite there being losses in the year and a potential deferral of certain creditor payments, no work was performed on a declining growth model prepared by the audited entity, and no consideration was given to the possibility that this scenario would occur. In light of these matters, further sensitivity analysis should have been performed on the base case model, prepared by the audited entity.

In one audit, there were concerns raised, at the planning stage, by the audit team over the lack of a fixed asset register and the potential implications of this, in particular in relation to the carrying value of the fixed assets. The audit team noted that the concerns were mitigated by a number of factors including: a fair value exercise carried out in 2009, impairment testing performed by management in the current year and increases in mineral reserve estimates, provided by experts, which were used to calculate the life of the assets for the purposes of depreciation. There was, however, insufficient challenge of management; evidence of the review of key assumptions; and evidence that either the prior or current year mineral resources and reserves estimates had been reviewed. There was also no evidence that the competence and objectivity of experts, internal and external to the group, had been considered.

Independent third party confirmations

On four audits, third party confirmations were requested in relation to investment securities, cash and cash equivalents, loans and advances to banks and in relation to swap agreements. On three of the audits the confirmations were not received and alternative procedures carried out did not provide sufficient evidence. On the other audit, although the confirmations were not received, no alternative procedures were performed.

Loss of audit work papers (in particular in relation to property valuations)

In one audit, there was a significant loss of audit work papers, caused by a computer crash prior to the date the audit report was signed. These work papers included support for the verification of property numbers, payroll proof-in-total workings, an assessment of three valuation experts and evidence of review and challenge by the audit team of the appropriateness of these experts' findings, which despite the electronic file being rebuilt, remained missing.

In addition, a hard copy valuation report supporting the commercial property valuation had been lost.

From the available records, we were unable to determine whether sufficient audit work had been performed by the team at the date the audit opinion was signed. (See below regarding the related quality control implications.)

Recurring findings

In response to findings from our previous inspections, the firm has taken steps designed to achieve improvements. These steps include: reducing the use of substantive analytical review, which previously was not performed well by audit teams, and increasing other tests of detail; and improving mandatory audit steps for the testing of journals, including the use of data extraction and interrogation software.

In our previous inspection we raised a finding related to understanding the business and the client. The information and understanding that Auditing Standards require the auditor to obtain was evident on the audit files, but it was recorded in various parts of the file based on the source of the information rather than being brought together and considered in one place.

Other findings

Communicating with Audit Committees

Certain aspects of the reporting to Audit Committees or their equivalent required improvement on all ten audits.

In nearly all of the audits reviewed, the risks reported to the Audit Committee covered significant[2], key and other risks without distinguishing between them. In addition, certain risks were reported at the planning stage but not at completion, and certain other significant risks were not reported at all. In our view, all significant risks identified should be reported to the Audit Committee at both the planning and completion stage.

In four audits, there were disclosure omissions or other errors in the financial statements which were not reported to the Audit Committee.

In one audit, the report to the Audit Committee did not communicate the full extent of a contract's future losses based on the forecasts extant at the time.

Quality control and audit finalisation

Audit finalisation procedures were generally adequately performed. However, in one audit, due to a computer crash prior to the audit report being signed, the audit file had to be rebuilt from earlier backups and from other information sources. The firm's archiving period was extended to facilitate this process and, as a consequence, there were a number of late-dated embedded documents and sign offs on the file. There also remained some missing audit evidence in significant areas. We consider that the procedures undertaken by the audit team to reassemble the audit file were

[2] A significant risk is defined within Auditing Standards as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

inadequate, as the evidence to support the audit opinion should have been re-obtained prior to it being signed.

The audit team did not comply with the firm's policy for the backing up of electronic audit files, which if followed should have prevented the incident that occurred.

2.2. Review of the firm's policies and procedures

The firm's policies and procedures are developed in the UK, within the context of the minimum requirements of the Grant Thornton International guiding principles. The firm's audit methodology and software is developed and maintained by Grant Thornton International, with considerable input from the UK firm.

The firm's overall strategy for the next three years targets growth. Emphasis is given to the quality of the firm's work as a means of achieving that growth and messages relating to audit quality are communicated to partners and staff regularly. Nevertheless, there is, in our view, a risk that audit quality may be adversely affected in practice by the strategy to target growth.

In March 2012 the Audit Commission announced the provisional award of contracts to Grant Thornton in the North West; West Midlands; London (South), Surrey and Kent; and the South West, which would make the firm the largest supplier of audit services to local authorities and the NHS. The five year contracts began in September 2012. As a result 300 professional staff from the Audit Commission have transferred to Grant Thornton to join its existing team in delivering audit services for local authorities and the NHS. In addition, Grant Thornton will be expanding its public sector graduate recruitment programme and recruiting IT and other public sector specialists to support its enlarged practice.

The firm has plans in place to ensure that the transferred staff are trained in respect of the firm's audit methodology and software, and achieve appropriate audit quality standards. The implementation of these plans and the firm's assessment of their success will be considered during our next inspection.

Improvements made since our last inspection

The firm took action to address our prior inspection findings and improved its procedures where necessary. In particular, new ethics training has been developed and has started to be delivered. The ethics queries system is now in operation; queries are still raised by e-mail to the Ethics Partner, however, and the firm is considering ways of encouraging use of the queries system.

The firm has developed a number of initiatives which are intended to embed professional scepticism in the culture of the firm; this includes a focus on coaching to develop individuals and encouragement of critical thinking. Nonetheless, as detailed above, our findings suggest that more needs to be done to achieve changes in practice.

The firm has also developed a new process to monitor completion of mandatory training and ensure that action is taken for non-completion where relevant. Whilst this responded to the concerns raised in our prior year report, the timing of the monitoring process should be improved to enable a programme of catch-up training to be scheduled for those yet to complete their training on a more timely basis.

For 2012 further, explicit, financial measures to reflect both good and poor audit quality findings in the reward structure for partners, directors and managers have been introduced. The audit quality findings considered are those arising from internal and external file reviews.

Rotation

For two audit partners, there remain a number of (non-public interest) audits, as identified during our prior inspection, where the audit partner has been involved for 20 years or more and the only safeguard is the appointment of an independent review partner. The firm is addressing this finding by re-allocating the engagements as part of succession planning but this is still in progress.

Training

In response to findings raised in our previous inspection, one of the firm's responses was that audit training for post-qualified staff would be developed to enhance knowledge of the new Auditing Standards. However, whilst guidance has been issued, this specific training had not been developed at the time of our inspection.

Quality objectives

In order to check compliance with the firm's requirement for audit partners and staff to include a quality objective when setting their objectives for the year ahead, the firm undertook to introduce sample checks of appraisal forms. However, whilst all audit partners and staff were reminded of the requirement to set an audit quality objective, these checks had not been carried out at the time of our inspection.

Findings in the current period

We identified certain areas where improvements to the firm's policies and procedures are required, as set out below, which need to be addressed.

Methodology - Significant risks

The firm's methodology does not require audit teams to identify significant risks as required by Auditing Standards. Instead it requires reasonably possible risks of material misstatement, a lower threshold, to be identified. By having a requirement to identify risks at a lower threshold, there is a risk that audit teams do not ensure that special audit consideration is given to significant risks and that they are not separately communicated to the Audit Committee.

Annual appraisals and partner promotions

From the sample we reviewed, a number of partner and staff appraisal forms, and two applications made for promotion to partners, made reference to the selling of non-audit services to audited entities.

Whilst we recognise that the ability to generate new work for the firm may be an important consideration, in these cases the individuals appeared to be seeking credit for their success in selling non-audit services to entities they audited which is not acceptable under the Ethical Standards.

The firm has informed us that the references made were not taken into account when evaluating performance, or making promotion or remuneration decisions for these individuals. However, there was no evidence that the inclusion of this material had been challenged. The firm needs to ensure that its partners and staff do not believe that recognition for selling non-audit services to audited entities will be given in practice. Any references in appraisals or promotion applications seeking such recognition should therefore be challenged.

Significance of findings from the firm's annual quality review

The firm's annual quality review processes are generally detailed and well controlled, with a well-structured moderation process.

In a number of instances, however, the findings of the firm's 2011 annual quality review appeared, in our view, to be of greater significance than recorded in the final results of the individual file or office reviews. This was also apparent on individual file reviews where the collective findings did not appear to be consistent with the grades awarded. On a number of individual reviews, what we viewed as significant findings were characterised as documentation matters rather than audit evidence issues. This was supported by our findings on the audit we reviewed that had also been reviewed as part of the annual quality review.

Finalisation of the 2011 internal annual quality review report

We noted in our previous inspection that the 2009 National Annual Review (NAR) findings were not reported to the National Leadership Board on a timely basis. Whilst this was improved for the 2010 NAR, the December 2010 target date was not achieved.

The 2011 NAR was performed in October 2011 and finalisation of the report was planned for 31 March 2012. Whilst the report was effectively final in May 2012, at 30 September (the date we completed our fieldwork for the current inspection) it had not been formally finalised (ie the report remained in draft format). Therefore, the findings were not formally finalised and reported to both the National Leadership Board and the audit partners and staff. The annual quality review process needs to be completed on a much more timely basis.

Audit reports

The firm's 2011 annual quality review identified issues regarding the signing of two audit opinions in two offices.

In the first case, the appointed Senior Statutory Auditor was unable to sign the audit opinion and another registered Responsible Individual of the firm, from the same office, signed the report, but in the name of the (absent) Senior Statutory Auditor.

In the second case, the audit report was dated 18 April, a day that the audit partner was on holiday. Resolution of a final internal review point was on 18 April and was documented as having involved the audit manager and review partner. It was not clear how the audit partner was involved in taking responsibility for the final decision regarding this matter nor how the audit report was issued on that day in the absence of the audit partner.

As issues surrounding the appropriateness of individuals signing audit reports have been identified in prior years, the firm should also consider the adequacy of actions taken to date.

Other matters

Passwords

In October 2012, the firm discovered that the process for changing electronic passwords, within the audit software system, had been abused by one individual. Whilst the results of the firm's investigations do not suggest that inappropriate password resetting is a systemic issue, it is our view that the underlying system weakness needs to be addressed.

Transparency report

We reviewed the firm's transparency report for the year to 30 June 2011, which was published in September 2011, to assess whether the information in the report was consistent with our understanding of the firm's quality control and independence procedures. We did not identify any inconsistencies with our understanding of the firm's quality control and independence procedures.

Andrew Jones

Director

Audit Quality Review

FRC Conduct Division

21 March 2013

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 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 also assess the extent to which the firm has addressed the findings arising from its previous inspection.

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.

Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

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

Basis of reporting

We exercise judgment in determining those findings which it is appropriate to include in our 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 our 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.

While our public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review 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 our inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied. As a result, there may be a significant period of elapsed time between the completion of our inspection fieldwork at a firm and the publication of a report on the inspection findings.

We also issue confidential reports on individual audits reviewed during an inspection. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide copies 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

The Firm's response is on the following page

Grant Thornton

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7 March 2013

Dear Mr Jones

Inspection of Grant Thornton UK LLP – 2011/13

We are pleased to respond publicly to the report of the Audit Quality Review Team on its 2011/13 inspection of Grant Thornton UK LLP.

The AQRT has recognised the significant improvements that we have made in procedures and their implementation, including those that responded to the findings of the 2009/11 inspection. We have already put in place a plan to address the additional findings raised on this inspection.

We are very pleased with the increasing proportion of reviewed engagement files that were graded "good standard with limited improvements required", demonstrating that our continued focus on audit quality is having effect. We are naturally disappointed with having any files that were considered to require "significant improvements" and are further refining our practices in identified areas to ensure that Grant Thornton's reputation for being committed to the highest levels of audit quality remains.

The achievement of our ambitions for the next three years is critical to provide the competition and choice that the global and UK audit markets require, as highlighted by the recent Competition Commission findings. The cornerstone of our ambition is based on the quality of our audit service, and providing real insights to our clients, based on reason and instinct.

We thank the AQR team members personally for the professional way they have conducted their review of our firm and appreciate the insights they have provided, that enable us to further enhance and improve our reputation for audit quality.

Yours sincerely

Mark Cardiff
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