Public Report

Financial Reporting Council

March 2013

BDO LLP

Audit Quality Inspection

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Contents

1. Background information and key messages

1.1. Introduction

This report sets out the principal findings arising from the inspection of BDO LLP ("BDO" or "the firm") carried out by the Audit Quality Review Team of the Financial Reporting Council ("the FRC"). We currently inspect BDO approximately every two years, our previous report having been published on 26 July 2011. Our current inspection was conducted in the period from July 2012 to November 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 seven audit engagements undertaken by the firm. These related to FTSE 350 and other listed entities, with financial year ends between April 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 audit 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 period findings on this audit had been addressed.

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 year. 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 BDO LLP in the conduct of the current inspection.

1.2. Background information on the firm

BDO LLP is a UK limited liability partnership with 14 offices. The Guernsey office, which was previously a separate partnership, merged with the firm in January 2012. It is a member of BDO International, a global network of firms using common audit methodology and audit software. This report excludes the BDO Northern Ireland firm, which is a separate partnership, and the Guernsey office.

For the year-ended November 2011, the firm's turnover was £281 million, of which £88 million related to audit work and other assurance services. There were a total of 177 partners of whom 63 were authorised to sign audit reports and 29 employees (audit directors) who were authorised to sign audit reports.[1]

We estimate that the firm audited 55 UK entities within the scope of independent inspection as at 29 February 2012. Of these entities, our records show that 18 had securities listed on the main market of the London Stock Exchange, including four FTSE 250 companies.

In addition, 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's records show that it has one such audit, a FTSE 100 company, which falls within the scope of our review.

[1] As disclosed in the annual return to the ICAEW as at November 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 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. They may also reflect the degree of autonomy which the firm gives to individual audit engagement partners in certain areas.

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 demonstrates its commitment to enhancing audit quality by implementing changes to its audit procedures and processes in response to deficiencies identified in quality reviews at the earliest opportunity.

- Encourage individual partners to demonstrate their personal commitment to audit quality by being more receptive to dealing with deficiencies identified in quality reviews.

- Monitor the effectiveness of actions taken in cases where individual audits have been found by external or internal quality reviews to require significant improvement and to address recurring issues identified by such reviews.

- Take action to improve the effectiveness and timeliness of Engagement Quality Control Reviews.

- Further emphasise the need for appropriate scepticism by audit teams in relation to key assumptions made by management and other areas in which significant judgment has been applied.

- Review the firm's audit strategy and remove any references that focus on, or could be interpreted as focusing on, the cross-selling of non-audit services to audited entities. Ensure that audit partners are aware of this change and that performance evaluation and remuneration decisions will not reflect success in selling other services to audited entities.

- Monitor action taken to address the significant deficiencies identified in the firm's ethical processes and guidance and ensure that resources are appropriate and sufficient to identify and respond to threats to independence in an appropriate and timely manner.

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 prior inspection

We undertook one follow-up review of an audit we reviewed in our previous inspection. We were disappointed to find that certain issues arising from our 2009 review had not been adequately addressed and that additional matters arose as a result of some of the changes made. We expect the firm to monitor more closely the effectiveness of actions taken in response to our findings.

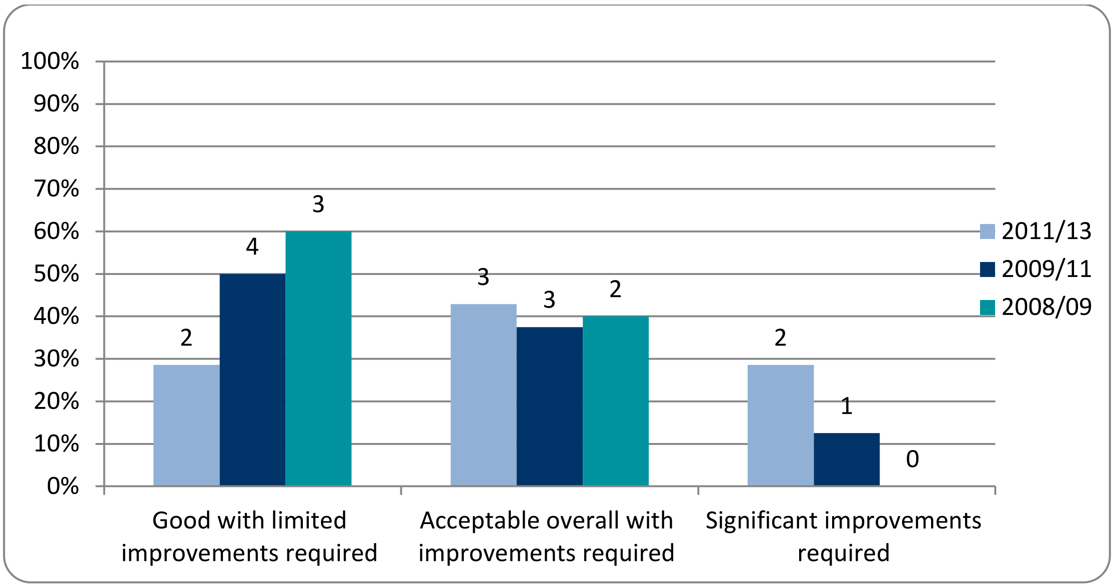
Audits reviewed in the current inspection

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

In our view, two of the audits we reviewed (2011: four) were performed to a good standard with limited improvements required and three audits (2011: three) were performed to an acceptable overall standard with improvements required. Two audits (2011: one) required significant improvement in key areas; one in respect of a lack of appropriate involvement in the conduct of the group audit and the other in respect of the audit of revenue, fixed assets and stock.

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 reviewed in our 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 the 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 implication of such findings for our overall assessment of an audit depends on their significance in the context of the audit.

Professional scepticism

On five audits we identified concerns about the level of professional scepticism applied in key audit areas. In one audit, the audit team did not appropriately challenge the inputs to management's collective impairment model. On a further audit, there was a lack of challenge of management in relation to the appropriateness of valuing plant, machinery, land and infrastructure on a fair value basis.

On a further two audits, the audit team failed to challenge appropriately explanations received from management; in one case relating to a reallocation of payroll costs that improved reported gross margins and in the other to management's lack of a calculation to support a key assumption in their model used to assess impairment of goodwill. Furthermore, in one audit the audit team did not show appropriate scepticism when reporting to the Audit Committee on the directors' valuation of a property asset, which was in excess of a third party valuation.

Group audits

On three audits we identified concerns over the group team's planning or supervision of the group audit.

On one audit all of the operations and the head office were overseas where all primary audit work on the books and records, including the audit of the consolidation, was performed. There was insufficient evidence that the group audit team had adequate involvement in the conduct of the group audit, including the audit of the group consolidation process.

On two audits, component materiality was set at the same level as group materiality, rather than a lower level as required by Auditing Standards. On a further audit, the basis for identifying significant components by size and risk was not clear.

Recurring findings

In response to our previous inspection findings, the firm has taken steps to achieve improvements. However, these have not been fully effective as demonstrated by the recurring findings set out below.

Audit of disclosures

On five audits we identified certain disclosure deficiencies. These had not been identified by the audit team and reported to the Audit Committee.

This issue has arisen on the prior two inspections and calls into question the quality of the firm's overall review of disclosures.

Related party transactions

Issues were identified on three audits relating to the audit of related party transactions. These included the adequacy of work performed relating to the identification of related parties, whether transactions were on an 'arm's length' basis and whether appropriate disclosures had been made.

Other findings

Communicating with Audit Committees

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

On two audits the audit team reported to the Audit Committee that the safeguard to address threats to independence arising from providing tax compliance services to the audited entity was the use of a separate tax team. This was incorrect as all or some of the tax compliance team were also used to assist in the audit of the tax disclosures included in the financial statements. Consequently, the Audit Committee was not in a position to assess the adequacy of any safeguards put in place.

Engagement Quality Control Review partner (EQCR)

On three audits there was insufficient evidence of the extent of the EQCR's review and only two to four hours were charged by the EQCR to the audit. On two of these audits we concluded that the audit required significant improvements and a more thorough review by the EQCR should have identified audit quality issues.

Audit reports

On two audits we identified omissions in the audit report. In one audit, the auditor's report did not refer to one of the primary statements. In the other audit, part of the audit report was omitted and included in error within the final note to the financial statements on related parties. Both these matters should have been identified by the firm's review processes.

2.2. Review of the firm's policies and procedures

Policies and procedures are developed by BDO International, with significant input from the UK firm.

Improvements made during the period

The firm took action to address our prior inspection findings and improved its procedures in certain areas. In particular, in the prior inspection we identified that the firm had taken action to ensure that there was a clear linkage between a number of audit quality inputs and partner appraisal and remuneration decisions. The firm have further enhanced this process in the 2011/12 appraisal cycle to ensure its leadership team has oversight of how audit quality findings are reflected in partner objectives.

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.

Tone at the top

The firm's Audit Stream Business Plan stated that "We will be increasingly aggressive in our prices if the circumstances justify it. Specifically, where we have excess capacity at times in the year or the prospect is likely to generate significant secondary spend…"The inference that fees should be set lower if significant non-audit fees are likely to be earned is contrary to the Ethical Standards, which state that audit fees should not be influenced by the actual or potential provision of non-audit services.

The firm's Audit Stream Business Plan set the Audit Stream goals in accordance with the firm's six strategic goals. The provision of non-audit services to audited entities appeared to be identified as one of the six strategic goals.

Further, an audit group mandated the use of the firm's Managed Clients Programme, which included a key performance indicator to cross sell to audited entities. Ethical Standards state that the performance evaluation criteria for members of the audit engagement team should not include success in selling non-audit services to the entity they audit.

We have commented on these and similar matters in the past, as they are unacceptable and must not continue.

Partner and staff appraisals

Partner appraisal forms included targeted and actual billings for audited entities including fees for non-audit services. Whilst the partner appraisal form template appropriately stated that sales targets for audit partners must exclude cross-selling non-audit services to audited entities, the targets included on the appraisal forms we reviewed were not in line with this requirement.

The staff appraisal forms in the sample we reviewed did not make any explicit reference to audit quality. The forms contain guidance to include audit quality considerations but, unlike the partner appraisal forms, do not have a separate section to address audit quality indicators.

Mandatory training

Audit partners are required to attend annual mandatory audit training and attendance is centrally monitored. Partners are expected to ensure that the key audit and quality messages are included in local office or business unit training for audit managers and staff. However, in 2011 there was no audit training classified as mandatory for audit managers.

Prohibited entities list

As part of the process to maintain its independence from entities it audits, the firm maintains a list of entities in which partners and staff are not permitted to hold shares. In the period from May 2011 to February 2012 the firm identified errors in this list, including one AIM listed entity that had been omitted from the list since 2007. As a result, four instances were identified by the firm in the inspection period where partners held shares in listed companies audited by BDO, contrary to the requirements of Ethical Standards. These cases were referred to the appropriate regulatory committee. The firm has now put in place a more robust set of procedures to ensure the list is kept up to date.

Approval of non-audit services

The engagement partner is required to record the reasoning for a decision to undertake an engagement to provide non-audit services to an audited entity and to consider the need for safeguards using a Relationship Risk Review (RRR) form. The RRR form includes a checklist of scenarios and decision trees, which leads to a conclusion on the threats to independence.

The RRR form does not comply with certain requirements of the Ethical Standards; has not been updated for the 2010 revisions to the Ethical Standards; and does not specify when consultation with the Ethics Partner is mandatory. There is a risk that the firm may be accepting non-audit engagements for audited entities without fully considering the threats to independence.

Annual declarations process

The firm required partners and staff to complete annual declarations, which covered financial interests held and other independence considerations, by November 2011. In March 2012 a number of matters raised in the declarations had still not been concluded upon by the firm.

Internal quality review findings

The firm produces an overall summary report of its audit quality monitoring findings for each business unit, with an action plan to improve audit quality. For one business unit, however, the overall summary report was not produced. Further, the level of detail and clarity of explanations on significant findings continues to vary. For certain reviews, the basis for the conclusion reached as to whether the audit was performed to a satisfactory standard was unclear.

Other matters

Transparency report

We reviewed the firm's transparency report for the year to 29 June 2012, which was published in September 2012, 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 the work which we 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 its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in our overall inspection programme for the relevant year. 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

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7 March 2013

Dear Sirs

BDO LLP - Response to AQR Public Report 2011/13

BDO LLP is pleased to submit its response to the Audit Quality Review Public Report on the 2011/13 inspection of the firm.

We welcome independent inspection of our audit process and the AQR's findings and observations assist us in achieving our shared objective of improving audit quality.

It is pleasing to note from the report that we place emphasis on audit quality and that in most areas we have appropriate policies and procedures in place for our size and the nature of our client base. Nevertheless, we recognise the importance of enhancing certain areas and since being made aware of the AQR observations we have made considerable progress in implementing actions to address these.

Our Transparency statement provides further information on our approach to delivering audit quality and is available on our website: www.bdo.uk.com.

Yours faithfully

BDO LLP

BDO LLP

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