

# Audit Quality Inspections

Annual Report 2011/12





This report is issued by the FRC's Audit Inspection Unit. It has been approved for publication by the Professional Oversight Board.

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# 1 Introduction and key messages

## 1.1 Introduction

This report provides an overview of the audit quality inspections undertaken by the Audit Inspection Unit (“AIU”), part of the Financial Reporting Council’s (“FRC”) Conduct Division, in the year ended 31 March 2012 and has been approved by the Professional Oversight Board (“POB”). It describes the more important findings from our inspections, and in particular includes key messages that we believe should be helpful to all audit firms and audit committees.

## 1.2 Structure of this report

This report is set out under the following sections:

- Section 1 includes our key messages to audit firms and audit committees,
- Section 2 provides an overview of the 2011/12 inspection findings,
- Section 3 summarises the inspection and other activities undertaken in 2011/12,
- Appendix A provides information on the inspection process and basis of reporting, and
- Appendix B details the scope of inspections for 2011/12.

## 1.3 Key messages to audit firms

We have seen an improvement in overall inspection results, with a further reduction in the proportion of audits requiring significant improvements. These now account for less than 10% of the audits reviewed. The proportion of audits assessed as good with limited improvements required remains consistent with previous years at around 50% of the audits reviewed<sup>1</sup>.

Firms respond to issues that we raise and improve their processes and procedures. We refer to some examples in this report. Those improvements do not necessarily have immediate results and so sometimes we find ourselves identifying issues which firms have already taken action to address. It is important that firms monitor the effectiveness of their actions, and that these are embedded in practice by partners and staff.

The more important matters arising from our inspection activities to which we expect firms to pay particular attention in order to continue to improve overall audit quality are set out below. These are discussed in more detail in section 2.

### Focus on audit quality (Section 2.3.2)

- Audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should establish central safeguards to ensure that total audit hours, the determination of materiality and the extent of work performed are maintained at an appropriate level to protect overall audit quality, particularly where significant fee reductions have been agreed.

### Professional scepticism (Section 2.3.3)

- Firms have undertaken a number of good initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. However, changes in behaviour have not yet been fully achieved and in certain areas, such as the impairment of goodwill and other intangibles, we have yet to see any significant impact. Further action is required to embed the application of professional scepticism within the audit.

### Financial services (Section 2.3.4)

- In inspecting the audit of loan loss provisioning by a number of banks and building societies, we had concerns that there was insufficient challenge to the assumptions in, and adjustments to, models used to determine collective provisions. We also continue to be concerned at the extent to which data about forbearance arrangements is available to auditors assessing the sufficiency and appropriateness of loan loss provisioning.
- We will continue to focus on the quality of audit work in this important sector, working closely with the Financial Services Authority (“FSA”).

<sup>1</sup> Our approach to grading is discussed further in section 2.1.

## Impairment of goodwill and other intangibles (Section 2.3.5)

- In addition to concerns about the level of challenge to key assumptions used in impairment testing calculations, we found that audit teams did not always fully understand the accounting and reporting requirements in this area and were, therefore, not identifying errors and inconsistencies in these calculations and disclosures. Firms need to provide further training to staff to improve their understanding of the accounting and reporting requirements.

## Group audit considerations (Section 2.3.7)

- Recent changes to Auditing Standards in respect of group audits were intended to raise performance generally to the level of best practice. However, not all firms and engagement teams recognised the need for improvement. As a result a number of problems were identified, particularly in relation to the group auditor's level of involvement in the planning stage of the audit. Firms should emphasise the importance of these revised requirements and ensure that the involvement of the group auditor in the audit of a business component has a clear purpose, and that auditors are able to demonstrate how they have fulfilled the requirements of the Standards.

## Auditor independence (Section 2.3.13)

- The effective identification and assessment of threats, the application of appropriate safeguards and the proper reporting of these to audit committees are critical to maintaining auditor independence. We are not able to report any improvement and firms should reconsider the adequacy of their procedures, and the training of audit staff, in this area.

## Engagement quality control review (Section 2.3.15)

- Firms have responded in different ways to improve the effectiveness of their engagement quality control reviews. We will continue to focus on whether these initiatives are making a difference in practice. We expect the engagement quality control reviewer to give particular attention to the extent to which appropriate professional scepticism has been exercised in key areas of judgment.

## Financial statement review processes (Section 2.3.16)

- Firms recognise the importance of pre-issuance technical reviews of financial statements as a quality control procedure which contributes to improving the overall clarity, quality and sufficiency of financial statement disclosures and provides evidence supporting the audit opinion. All major firms mandate some form of pre-issuance technical review. There are, however, differences in their review policies and procedures.
- Such reviews should cover all listed entities as a minimum and be performed by appropriately experienced staff independent of the audit team. Evidence of such reviews should be retained, together with details of how significant points arising have been cleared. We expect firms to revisit their arrangements for pre-issuance reviews to ensure they are robust and in line with best practice.

## 1.4 Key messages to audit committees

Audit committees play an essential role in ensuring the quality of financial reporting. In particular, their work with auditors in planning the audit and reviewing its results contributes greatly to the quality of that audit. To assist audit committees, we highlight below a number of our findings which we believe will assist their oversight of the audit process and contribute to an overall improvement in audit quality.

### Impact of fee reductions

- A company's audit should represent value for money. Nevertheless, substantial fee reductions may lead the auditor to reduce valuable audit work and therefore compromise audit quality. We are seeing evidence of audit firms making such cuts.
- Where fee reductions have been offered, audit committees should scrutinise the proposed scope of the audit, including the determination of materiality, and the attention to be given to each business component and to the significant audit risks identified. Where there are significant changes in these following a reduction in audit fees, audit committees should consider whether the overall level of work to be performed is likely to be sufficient to identify material misstatements and ensure that audit quality is not compromised.

## Professional scepticism

- We have been and remain critical of the extent to which auditors have sometimes failed to exercise appropriate professional scepticism in relation to key judgments. Audit committees have an important role to play in supporting and encouraging a sceptical approach. In particular, audit committees should be prepared to discuss the concerns of audit teams about management's key judgments. Equally audit committees should encourage audit teams to demonstrate the extent of their challenge in relation to key judgments, even where the final audit judgment supports management's views. This might include information about the alternative approaches that were considered and why the approach adopted was considered appropriate in the circumstances.

## Group audit planning

- When reviewing the annual audit planning report, audit committees should consider whether this includes sufficient detail on the extent to which the group audit team has been involved in the risk assessment and determination of procedures to be performed in respect of significant components of the business.

## Auditor independence

- Any threat to auditor independence from the provision of non-audit services should be reported to audit committees whilst there is time to mitigate the risk. Sufficient detail should then be provided to enable an informed assessment as to whether auditor independence has been maintained. Auditors are sometimes too ready to underestimate the threats, and argue without proper consideration that current arrangements are sufficient safeguards against those threats. Audit committees are entitled to expect a good standard of independence reporting from their auditors and should seek additional information where it is not initially provided.

## 1.5 Effectiveness of audit quality inspections

The UK audit inspection regime is among the most transparent in the world. We report our findings clearly and we believe that this transparency contributes to a continuous and sustained improvement in overall audit quality.

At the same time, because the focus of our reporting is on those aspects where improvement is required, our reports may leave the impression that there are more problems with the quality of auditing in the UK than elsewhere. However, discussions with overseas regulators confirm that the issues raised in the UK are very similar to those raised internationally and therefore this impression is incorrect.

We provide written reports on reviews of individual audits, and require written responses to the more significant of our findings. Firms are expected to take action to deal with all such findings, and we generally see improvements in audit quality when we carry out follow-up reviews in subsequent years. Nevertheless, there are some areas where further progress is required. A number of these are highlighted in the key messages section above. Often these require a change in culture and attitude before the required improvement in behaviour can be achieved. We will ensure that these areas continue to be reviewed in future years so that further improvements in practice continue to be made.

We are engaged in a number of other activities that contribute, directly and indirectly, to the overall quality of auditing:

- We provide feedback from our inspections to UK and international standard setters;
- We participate in a number of international forums, including the International Forum of Independent Audit Regulators;
- We have developed a closer working relationship with the Financial Services Authority; and
- We undertake other inspection activities, including those in the public sector and more recently for the Crown Dependency regulatory authorities.

We attach considerable importance to the effectiveness of our inspection approach and the quality and clarity of our reporting. The feedback we receive, particularly from audit committee chairs, is a valuable input to this process of continuous improvement and we welcome further comments and observations.

# 2 Overview of findings

## 2.1 Introduction

We reviewed 94 audits in 2011/12 (2010/11: 92 and 2009/10: 93) including 10 follow-up reviews (2010/11: 11 and 2009/10: 12). Most of these audits were in relation to financial statements for years ended 31 December 2010 or March 2011. We reviewed selected aspects of each audit, with emphasis given to the areas detailed in section 3.2, to enable us to assess the quality of the audit and to determine an overall grade.

For public reporting we use three grades:

- good with limited improvements required;
- acceptable overall with improvements required; and
- significant improvements required.

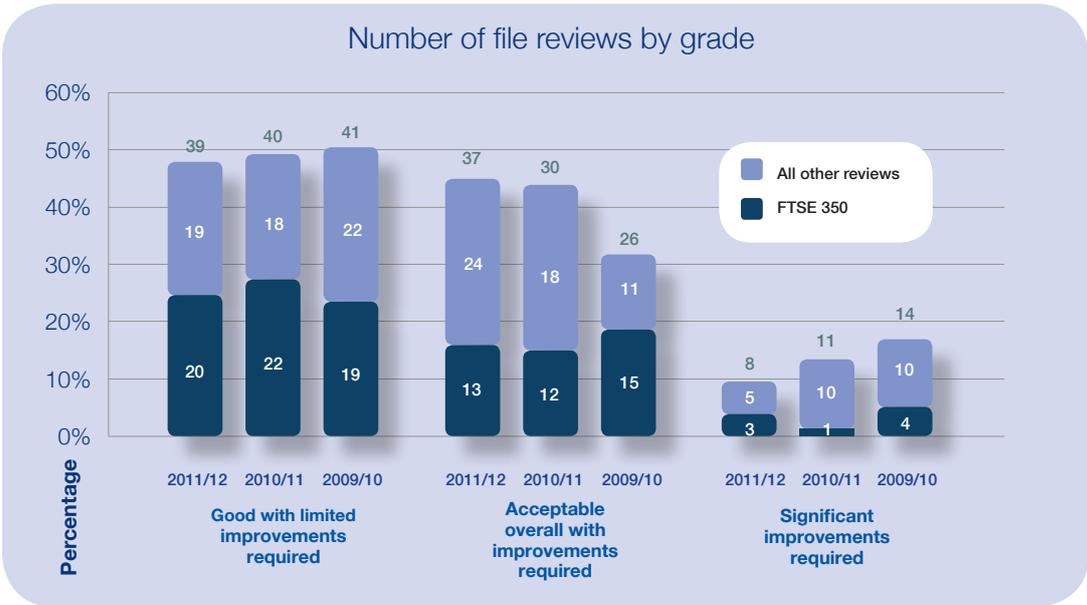
An audit is assessed as requiring significant improvements if we had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgments in one or more key audit areas or the implications of concerns relating to other areas were considered to be individually or collectively significant.

We focus our work on how a particular audit was performed. An audit makes a vital contribution to the confidence that may be placed on financial statements. It is important to emphasise, however, that our reviews are not designed to assess whether the information being audited was incorrectly reported and so a poor grading does not necessarily imply that the financial statements were materially inaccurate or incomplete, or that an inappropriate audit opinion was issued.

## 2.2 Assessment of audits reviewed

### 2.2.1 Overall findings

The file review gradings excluding follow-up reviews (84 audits in 2011/12 and 81 audits in both 2010/11 and 2009/10) are summarised in the table below<sup>2</sup>.



<sup>2</sup> Similar tables are included in our reports on individual firms. In these reports the tables present the file review gradings arising from the inspection of the firm which in some cases occurs across a two year period. This table however only includes the file review grades for each audit inspected across all firms in an inspection year. A direct comparison of this table with those in the individual reports is therefore not meaningful.

Almost 50% of the audits reviewed in 2011/12 were rated as being good with limited improvements required. This is broadly consistent with our findings in both 2010/11 and 2009/10. The number of audits requiring significant improvements has continued to decline to less than 10% of the audits reviewed. We nevertheless want to see a further decline in the number of such audits.

### 2.2.2 Audits requiring significant improvements

Of the eight audits assessed as requiring significant improvements in 2011/12, five related to listed companies, compared with six listed or AIM companies in 2010/11. The number of large listed company audits requiring significant improvements has increased (three FTSE 350 companies, compared with one in 2010/11).

A number of issues were common to more than one of these audits. The assessment of the impairment of goodwill and other intangibles and the sufficiency of revenue testing were identified as concerns in four audits. Deficiencies in the audit of going concern were noted in two audits and, in one of these instances, the entity subsequently ceased operations.

Of eight bank and building society audits one was assessed as requiring significant improvements including the adequacy of the evidence supporting the level of provisioning against mortgage loans. This compares with 2010/11 where the audits of three unlisted subsidiaries of overseas banks (out of 10 bank and building society audits reviewed) were assessed as requiring significant improvements.

At firms auditing ten or fewer entities within our scope the number of audits assessed as requiring significant improvements has also continued to decline, from four in 2010/11 to two in 2011/12. In one such instance, the firm subsequently concluded that it did not have the appropriate expertise to undertake the particular audit and resigned from the engagement.

### 2.2.3 Follow-up reviews

In relation to the 10 follow-up reviews undertaken in 2011/12 (2010/11: 11 follow-up reviews), we concluded that most matters identified previously had been satisfactorily addressed in the subsequent audits, leading to improvements in audit quality in the relevant areas.

## 2.3 Key 2011/12 inspection findings

### 2.3.1 Introduction

This section discusses matters arising from our 2011/12 inspections that are significant or which are common to a number of firms and where action is required to improve overall audit quality. We highlight a number of areas where we believe firms have made significant progress in addressing issues and note some examples of good practice.

We also discuss matters pertaining to the financial services sector, and in particular banking, given our continued focus on this sector and the heightened scrutiny it faces.

### 2.3.2 Focus on audit quality

Firms face significant pressures in the current economic environment and the level of tendering activity has increased. Substantial reductions in audit fees have occurred in a number of recent audit tenders for large listed entities.

In responding to these fee pressures firms have sought efficiencies and a reduction of overall audit hours. These reductions include the application of higher materiality levels which reduce the sample sizes tested and the reduction of the extent of testing in areas of low audit risk. In the context of group audits we have seen instances where materiality applicable to business components has been increased and the number of business components subject to full audit procedures reduced. These factors have caused us to have concerns about the sufficiency of work performed.

A number of firms are continuing to pursue “off-shoring” strategies where certain audit procedures are performed in off-shore locations, in order to reduce costs. While the extent of offshoring remains small, generally less than 5% of core audit hours, it continues to increase at a significant rate. Firms will need to ensure that their policies and procedures evolve in order to manage effectively any risks to audit quality associated with off-shoring.

Other examples of cost cutting initiatives include changes to the provision of staff training, a greater delegation of work to junior staff and an increased use of checklists.

While acknowledging that fee pressures are a commercial reality that cannot be ignored, we remain concerned that audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should ensure that they maintain appropriate controls centrally to ensure audit efficiencies are not achieved at the expense of audit quality, particularly where the extent of audit procedures performed are dependent on judgments relating to materiality, scoping or sample sizes.

### 2.3.3 Professional scepticism

Firms have undertaken a number of good initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. These include additional training and specific communications to staff from key management personnel. Some firms have integrated the demonstration of professional scepticism within their staff development and promotion processes. One firm now requires audit teams to demonstrate how professional scepticism was applied on high profile audits. Other firms should consider introducing such a requirement.

Professional scepticism is not a procedure or process; it is an approach to be adopted, and demonstrated, throughout the conduct of the audit. While we welcome the initiatives firms have taken in this area, improvements in behaviour have not yet been fully achieved, and in certain areas such as the impairment of goodwill and other intangibles which we discuss below, we have yet to see any significant impact. Further action is required to embed the application of professional scepticism within the audit.

### 2.3.4 Financial services

The scope of inspections<sup>3</sup> for 2011/12 was extended to include all UK building societies (previously only those building societies with assets exceeding £1 billion were included), having included all banks incorporated in the UK in the prior year. We reviewed 13 audits of financial services entities, comprising eight banks and building societies, three insurance companies and two other financial services entities. We also performed three follow-up reviews of bank audits.

The observations and findings set out below outline the most significant issues that we identified during our reviews of financial services audits in 2011/12.

While only one audit was assessed as requiring significant improvements, the issues discussed below indicate that further improvements are required in the standard of auditing in the financial services sector.

### Loan loss provisioning

We identified issues in connection with the audit of loan loss provisions in a number of bank and building society audits that we reviewed. Insufficient challenge to the assumptions and inputs to models used by management to determine collective provisions were a common issue. For example, audit teams did not adequately challenge adjustments made to the output of these models to deal with factors that the models did not otherwise adequately address (e.g. forbearance arrangements). In several audits, we also identified issues with the adequacy of audit procedures relating to management's assessment of specific loan provisions.

### Forbearance

The practice of entering into forbearance arrangements in relation to loans and advances to borrowers in financial difficulty continues to increase. We have been concerned for some time that data relating to such arrangements was not being captured completely or consistently to an extent sufficient to inform decisions about loan provisioning. As a consequence there is a risk that those underperforming loans are not identified for provisioning purposes. In our view, the auditors of financial institutions should perform audit procedures to determine whether such data is appropriately captured and taken account of by management as part of their loan provisioning exercise. Our 2012/13 inspections will consider progress in this area.

### Audit work in relation to fraud risks

Audit work in relation to fraud risks required improvement in the majority of bank and building society audits reviewed. Although not confined to financial institutions, our findings included instances where there was insufficient consideration of fraud risks arising from management override and no testing of management journals during the year or at year-end. Firms should ensure that the fraud risk of management override is fully included in audit planning procedures.

<sup>3</sup> Refer to Appendix B for the full scope of our inspections for 2011/12.

## Insurance: use of actuarial specialists

The audit of assumptions, such as morbidity and mortality assumptions, that are used in calculating insurance contract assets and liabilities is often complex and requires assistance from the firms' actuarial specialists. We identified a number of issues concerning the scope of the actuarial specialists' work, the integration of this work into the audit files and the quality of the audit team's review of this work.

## 2.3.5 Impairment of goodwill and other intangibles

The impairment of goodwill and other intangibles was an area of focus this year. We reviewed many audits where goodwill and other intangible assets were material, in order to assess the quality of audit evidence obtained to support the carrying value of these assets. As in previous years, a significant number of issues were identified in this area, including insufficient evidence of challenge to the key assumptions, and concerns regarding the adequacy of the related disclosures.

In general the level of challenge by audit teams of key assumptions was less robust than was appropriate given the current economic environment. Even where audit teams performed sensitivity analyses of key assumptions, these were often performed on individual assumptions and the combined effect of changes to a number of key assumptions was not considered. We concluded in some cases that a more rigorous assessment was needed to support the conclusion that no impairment was required. While the point at which impairments are recognised is always a matter of judgment, it was noteworthy that in at least one instance where we raised significant concerns, a significant impairment of goodwill was recognised in the half year results following our review.

Significantly, our findings suggested that audit teams did not always fully understand the accounting and reporting requirements in this area. This resulted in audit teams not identifying the mixing of pre and post-tax cash flows used to calculate value in use; accepting impairment reviews based on profit forecasts rather than cash-flows; failing to identify incorrect or incomplete calculations of the carrying value of the assets being tested for impairment; and failing to understand the calculation and determination of appropriate discount rates. These findings demonstrate that firms need to provide further training to staff covering these types of issues.

## 2.3.6 Going concern

As in previous years, various issues over the adequacy of the work undertaken in relation to the going concern basis for the preparation of the accounts were identified. These have included the extent of the work performed on financial projections supporting the going concern assessment, the adequacy of the disclosures relating to going concern uncertainties and the sufficiency of evidence of parental support material for going concern purposes. The latter was particularly relevant in the audit of UK trading subsidiaries of overseas banks we reviewed.

In one instance, we noted that the audit team had concluded that the status of negotiations relating to the renewal of banking facilities, which expired 13 months from the date of the audit report, was not central to their assessment of going concern. In our view, in the particular circumstances, the known expiry of the existing facilities and the status of the negotiations to ensure replacement facilities were in place should have been given greater emphasis by the audit team.

In light of the difficult economic environment and a number of recent high profile business failures, the audit of going concern will remain an area of focus.

## 2.3.7 Group audit considerations

Recent changes to Auditing Standards introduced more specific requirements for the conduct of group audits, including greater specification of the audit procedures to be performed and a requirement for greater involvement by the group auditor in the audit of significant components. These changes were intended to raise performance generally to the level of existing best practice. Group audit considerations were an area of focus this year.

The most common issue was the insufficient involvement of the group audit team at the planning stage of the audit when the business component auditor's risk assessments and planned audit procedures were to be considered.

Other specific issues included insufficient justification of the scoping and materiality of business component audit procedures, a lack of clarity in respect of the objectives and outcome of visits to component auditors, and the adequacy of the review of the business component auditor's work by the group audit team.

Firms should have regard to the fact that the requirements of Auditing Standards apply equally to business components audited in the UK by other teams independent of the group audit team, in the same way as they do to business components located overseas.

### 2.3.8 Revenue recognition

We identified a number of issues in relation to the recognition of revenue, including insufficient testing despite revenue recognition being identified as a significant risk, insufficient consideration of the risk of overstatement, and insufficient corroboration and challenge in respect of contract revenue.

Firms should ensure that their audit procedures are more focused on the risks associated with revenue recognition in view of the current economic environment and the pressure being placed on the financial performance of audited entities.

### 2.3.9 Determination of materiality

The level of materiality to be used is critical to the nature and extent of the audit testing performed and the assessment of issues arising from that testing. We have commented above on the pressures firms face to reduce costs in the current economic environment and the effect that this may have on setting audit materiality levels.

Auditing Standards require the materiality level for business components within a group to be set at a level lower than that for the group audit as a whole. We identified instances where this was not the case and where the level of materiality for a business component was not sufficiently justified.

One firm's methodology stated that materiality for individual account balances, classes of transactions and disclosures may be higher than overall materiality and that, if assessed as low risk, such items could be scoped out for audit testing purposes. That firm needs to revise its guidance to ensure appropriate scoping for audit testing purposes and adequate communication of the scoping to audit committees.

Auditing Standards require an auditor to determine both overall and performance materiality levels. At one firm, after we had concluded that the levels of overall materiality set were too high, we were informed that the firm had in fact instructed its audit teams to use the

lower performance materiality figure at all times. Such guidance is inconsistent with the rationale underlying the requirements of the relevant Auditing Standard. This may confuse staff and therefore should be revised.

We will continue to give consideration to policies and procedures developed by the audit firms relating to the determination of materiality, and their application in practice.

### 2.3.10 Use of experts and specialists

The use of the work of external experts and internal specialists continued to give rise to issues. In particular, insufficient challenge of the assumptions used by the expert was a key issue. Further, where audit teams chose to rely on the work of external experts, issues arose in relation to the consideration of the objectivity and independence of the proposed expert and the adequacy of their work for audit purposes.

Internal specialists are often used by audit teams to review areas such as taxation and actuarial calculations because of the complexities and specialist knowledge required. We recognise that the use of internal specialists is an important procedure that enhances audit quality. Firms should ensure that specialists apply appropriate professional scepticism and evidence their work in order that their conclusions, when reviewed by the audit team, can be seen to be adequately supported. Audit teams must also ensure that they give appropriate consideration to any issues identified by the specialists and that there is evidence that these have been appropriately resolved.

### 2.3.11 External confirmations

We continued to identify instances where audit teams did not seek independent third party confirmations to support the existence and value of assets held by an audited entity. On a number of occasions audit teams obtained copies of investment reports from the audited entity, rather than seeking to obtain direct confirmations from the investment managers. This was a particular issue in relation to the audit of pension scheme assets. Auditing Standards state that audit evidence is more reliable when it is obtained from third parties and we expect audit teams to plan and perform procedures to obtain such confirmations for cash and investment assets.

### 2.3.12 Testing the effectiveness of controls

The audit approach for the largest listed entities, large retailers and financial institutions generally includes some independent testing of the effectiveness of internal controls as sufficient audit evidence cannot be obtained on a timely basis from substantive testing alone. At all firms, however, the audit approach for other entities is generally focused on substantive audit procedures with only limited testing, if any, of the effectiveness of internal controls. We believe that there is scope for firms to improve the efficiency and effectiveness of their audit approaches by reviewing the extent to which audit evidence is obtained through their testing of the effectiveness of internal controls.

### 2.3.13 Auditor independence

The effectiveness of Ethical Standards is dependent upon auditors identifying and assessing threats to auditor independence and then mitigating those threats, where appropriate, through the application of safeguards. However, we identified a number of instances where audit teams did not appear to understand or appreciate the importance of this approach.

We are concerned that, more than seven years after the Ethical Standards were introduced, we are not able to report any improvement in this area. Firms must reconsider the adequacy of their procedures and training in this area. They should also increase the level of focus on this area in their own internal quality reviews.

As indicated in 1.4 above, the expectations of audit committees should help to ensure that auditors take this matter more seriously.

### 2.3.14 Reporting to audit committees

Reporting to audit committees was often of a good or acceptable standard and communications were generally made on a timely basis.

However, significant improvement is required in the reporting of the specific threats and safeguards for non-audit services to audit committees (as required by Auditing and Ethical Standards). Other deficiencies that we identified included inadequate reporting of audit findings, and inconsistencies and omissions in the reporting of significant risks. We expect firms to make further improvements in their quality control processes over audit committee reporting to ensure the standard of reporting is more consistent in the future.

### 2.3.15 Engagement quality control review (EQCR)

Auditing Standards require firms to perform engagement quality control reviews of the audits of all listed companies. Firms are also required to have policies in place specifying what other audits require such a review. We have for some time been concerned at the effectiveness of these reviews in practice.

Firms have responded to these concerns in different ways. At one firm, a small group of senior audit partners has been assigned responsibility for the EQCR review of all the firm's FTSE 350 clients. That firm introduced this process for its audits with December 2010 year ends. As part of our 2011/12 inspection we interviewed each of the reviewers. We noted that they had periodic meetings to share best practice, to promote consistency and awareness of issues arising. In our view, this change has contributed to the quality of the review process by ensuring a more consistent approach.

At another firm, the EQCR policy was revised to require reviewers to document the procedures that they performed in relation to key areas of the audit, such as significant accounting, auditing and financial reporting matters, the risks identified and the judgments made by the audit team. These changes emphasised the importance this firm places on the role of the EQCR and in particular ensured that there is appropriate evidence of the review procedures performed.

Notwithstanding these positive developments at some firms, we remain concerned at the lack of evidence generally of these reviews. In particular, there was limited evidence that the EQCR review had appropriately challenged the engagement team in areas of key judgments, including an assessment of the extent to which professional scepticism had been exercised, and limited evidence that underlying work papers had been reviewed and appropriate review points raised and cleared (most firms mandate that they be removed from audit files). There tended to be an over-reliance on checklists, which can create the impression that the review is a compliance function.

At those firms auditing ten or fewer entities within our scope, we noted that the EQCR reviews were sometimes performed by external organisations or, on occasion, by senior staff who were not authorised to sign audit reports. This caused us to question whether the reviews were being performed by individuals with appropriate experience and sufficient authority and,

therefore, whether the review process was effective. We will continue to review the operation and effectiveness of the EQCR process and whether the initiatives introduced by firms are making a difference in practice.

### **2.3.16 Financial statement review processes**

Pre-issuance technical reviews of audited financial statements are an important quality control procedure which contributes to the overall clarity and quality of the financial statements and the evidence supporting the audit opinion. Such reviews are most effective when performed by individuals with an appropriate level of technical expertise and sufficient authority. All major firms mandate some form of pre-issuance technical review. There are however differences across firms in terms of the coverage of such reviews, and by whom they are performed.

The coverage of these reviews varies from FTSE 100 and higher profile entities only, to all audited entities. The rationale for this divergence is not always apparent and, in our view, such reviews should cover all listed entities. Further, reviewers should confirm that any significant matters raised by them have been satisfactorily addressed prior to the audit report being signed.

In most firms some or all of the reviews are undertaken by experienced technical specialists. At some firms, however, we note that while a review is performed separately from the audit team, the seniority and experience of the reviewers varies and at one firm the output is not retained. We believe the retention of the output of technical reviews contributes towards the audit evidence relating to compliance with financial reporting and disclosure requirements.

### **2.3.17 Performance evaluation**

Our review of partner and staff appraisal documentation continued to find that insufficient emphasis is given to audit quality and that there was an absence of specific audit quality objectives against which performance could be assessed. Firms must ensure that the performance of partners and staff is appropriately evaluated against specific audit quality objectives and that there is a direct and proportionate impact on remuneration arising from adverse audit quality assessments.

## 3 Summary of activities

### 3.1 Introduction

This section provides a summary of our inspection and other activities undertaken in 2011/12.

### 3.2 Scope and coverage of inspections

We review the quality of approximately 100 statutory audits of listed and other major public interest entities that fall within scope and we review the firms' policies and procedures supporting audit quality<sup>4</sup>.

Firms which audit more than ten entities within our scope are subject to annual or biennial inspections and reports. There are currently ten such firms ("the major firms") being the Big Four firms<sup>5</sup>, Baker Tilly UK Audit LLP, BDO LLP, Crowe Clark Whitehill LLP, Grant Thornton UK LLP, Mazars LLP and PKF (UK) LLP.

Our inspections of firms that audit ten or fewer entities within our scope are limited to a review of a sample of individual audits<sup>6</sup>.

In 2011/12, we completed full scope inspections, comprising a review of policies and procedures supporting audit quality and of individual audits within our scope, at the Big Four firms, Baker Tilly UK Audit LLP, Crowe Clark Whitehill LLP, Mazars LLP and PKF (UK) LLP. Individual public reports summarise the findings from these inspections.

Inspections were also carried out at 11 other firms which audit ten or fewer entities within our scope, in each case comprising a review of one listed or other major public interest entity audit.

We currently inspect the Big Four firms annually. These firms audit approximately 80% of the entities within our scope, including over 95% of UK incorporated FTSE 350 companies. Our inspections at the other major firms are undertaken over an extended period of approximately two years. Reports on the findings of our inspections at BDO LLP and Grant Thornton UK LLP will therefore be published in 2013.

Each year we select a number of areas of particular focus. For 2011/12 these were: group audit considerations; the valuation of assets held at fair value; the impairment of assets (including goodwill and other intangibles); the assessment of going concern; revenue recognition; related parties; and the quality of reporting to Audit Committees. We continued to focus on banks and increased our focus on building societies given the level of public interest in the sector.

Our areas of focus for 2012/13 are largely unchanged from 2011/12, but will also include the recoverability of deferred tax assets.

The scope of our inspections increased following arrangements agreed with the regulatory authorities in Jersey, Guernsey and the Isle of Man ("Crown Dependencies"), to meet their obligation to ensure that audits of companies incorporated in these territories with securities that are traded on a regulated market in the EEA are subject to independent inspection. This is discussed in more detail in section 3.5. While all UK and Crown Dependency companies listed on the London market are now subject to our inspections, there are still other entities listed in London but incorporated elsewhere, that fall outside the scope of our inspections.

We also undertook inspections at both the Audit Commission and the National Audit Office. These public sector inspections are discussed in section 3.4 below.

<sup>4</sup> The Companies Act 2006, as amended, requires the independent inspection of auditors undertaking statutory audits of listed companies and other entities in whose financial condition there is considered to be major public interest.

<sup>5</sup> The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

<sup>6</sup> The Companies Act 2006, as amended, permits the delegation of inspection activities to the monitoring units of the Professional Accountancy Bodies for those firms conducting ten or fewer audits within our scope. The monitoring of firm-wide procedures in relation to these firms has been delegated.

### 3.3 Analysis of audits reviewed

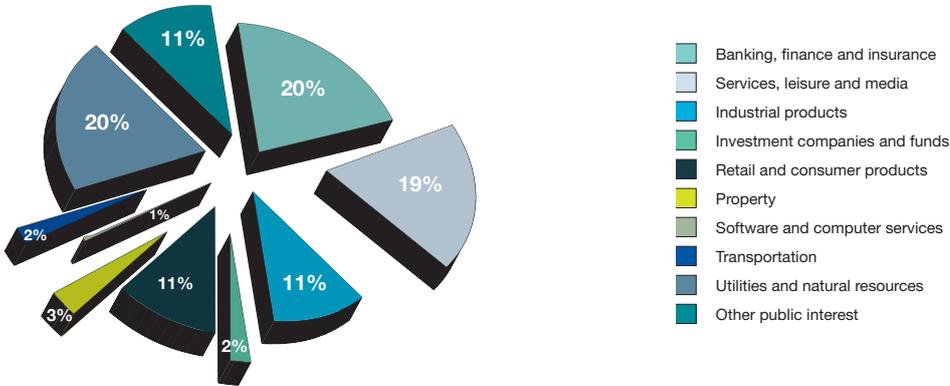
In the year to 31 March 2012, including reviews performed under contractual arrangements with the Audit Commission and the National Audit Office, we completed the review of 108 audits, compared with 107 in 2010/11. The audits reviewed in 2011/12 related to financial years ending between February 2010 and April 2011, with a significant proportion being 31 December 2010 year ends. An analysis of audits reviewed by type of firm is set out in the following table.

Firm type	File reviews 2011/12	File reviews 2010/11
<b>Major firms</b>		
Big Four firms-UK entities	52	61
Big Four firms-Crown Dependency entities	7	-
Other major firms-UK entities	21	19
Other major firms—Crown Dependency entities	3	-
Firms auditing ten or fewer entities within scope	11	12
<b>Total excluding public sector</b>	<b>94</b>	<b>92</b>
<b>Public sector</b>		
Audit Commission	4	4
Audit Commission – Appointed Firms	4	5
National Audit Office	6	6
<b>Overall total</b>	<b>108</b>	<b>107</b>

The above totals include 10 follow-up reviews (2010/11: 11 follow-up reviews).

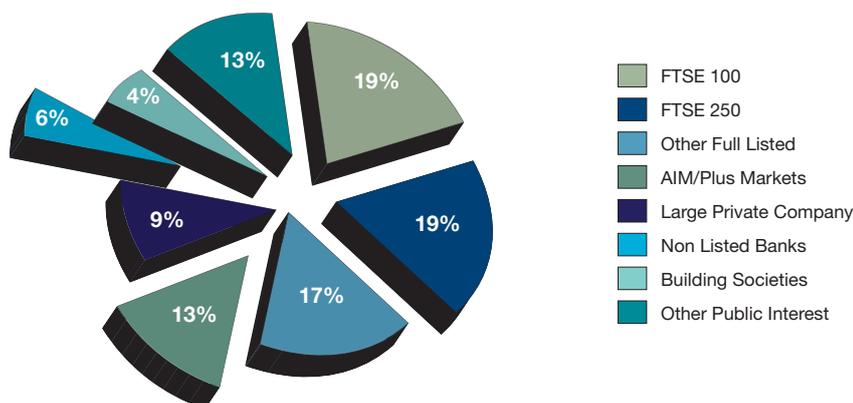
An analysis by sector of the audits reviewed in 2011/12 is set out below:

#### Audit files reviewed by sector 2011-12 (excluding public sector)



An analysis by type of organisation of the audits reviewed in 2011/12 is set out on the following page.

## Audit Files reviewed by type of organisation 2011-12 (excluding public sector)



Since we commenced inspection activities in 2004, we have reviewed in excess of 700 audits, including the audits of approximately 300 FTSE 350 companies.

We have developed a risk model covering listed companies, including AIM, which we use to inform the selection of audits to be reviewed each year. The majority of audits selected for review were drawn from those identified as higher risk within this risk model.

### 3.4 Public sector inspections

Our public sector inspections comprise the Audit Commission and firms appointed by it ("Appointed Firms") and the National Audit Office. Audits of public sector entities are outside our normal scope of inspections and the findings from these inspections are not subject to public reporting.

Our inspection at the National Audit Office is also undertaken for the purpose of the statutory oversight role of POB as the Independent Supervisor.

The cost of these inspections is met directly by the bodies concerned. They are undertaken in the first quarter of each calendar year, the period in which we undertake less inspection fieldwork at the major firms. Public sector inspections therefore contribute to the overall efficiency and cost-effectiveness of our inspection activities.

### 3.5 Crown Dependency inspections

Firms undertaking the audits of companies incorporated in the Crown Dependencies, with securities that are traded on a regulated market in the EEA, are now required to be subject to independent inspection. This requirement is derived from the EU's Statutory Audit Directive and the arrangements that have been put in place are designed to ensure that the Crown Dependencies have auditor oversight arrangements that are considered equivalent to those in place in EEA member countries.

In conjunction with the monitoring units of the professional bodies in the UK which register firms to conduct audit work, we have entered into arrangements with the Crown Dependency regulatory authorities to undertake these inspections on their behalf. We are responsible for inspecting all major UK audit firms registered to undertake the audits of relevant Crown Dependency companies, together with non-UK audit firms with more than ten relevant audits (currently KPMG Channel Islands Limited and PricewaterhouseCoopers CI LLP).

We commenced these inspections with effect from 1 April 2011, and undertook inspections at those major firms also subject to UK inspections in 2011/12. Our inspections in 2012/13 will, in addition to major UK audit firms, include KPMG Channel Islands Limited. The cost of these inspections will be met by the individual firms concerned.

One benefit of these inspection arrangements is that the audits of companies incorporated in one of the Crown Dependencies which are listed in the UK are now subject to our inspection. This includes a number of major FTSE 350 companies, including seven FTSE 100 companies.

### 3.6 Oversight of inspections by the professional bodies

We undertake certain oversight activities in relation to inspections by the monitoring units of the professional bodies in respect of firms auditing fewer than ten entities within our scope. This includes approval of the inspection methodology used to assess a firm's policies and procedures supporting audit quality and the assignment of inspectors to undertake this work. We also provide input to the monitoring units' inspection reports on each of these firms. This oversight provides an opportunity for collaborative working with the respective monitoring units and contributes to the overall quality of their inspection activities.

### 3.7 International liaison

As part of the FRC's on-going commitment to liaise with other independent audit regulators, we meet on a regular basis with similar organisations. We also participate in the International Forum of Independent Audit Regulators ("IFIAR") plenary meetings, working groups and inspection workshops and the European Audit Inspection Group, comprising independent audit regulators from within Europe. We note that there continues to be considerable commonality between our inspection findings and those of audit regulators in other major jurisdictions.

The emergence of Europe-wide firms such as KPMG Europe LLP and Ernst & Young Europe LLP, has required us to work closely with other regulators. To respond to these developments, we play a leading role in a college of regulators, which was established to facilitate the sharing of information and efficient inspection processes across these European firms.

Following the implementation of the Statement of Protocol entered into in 2011 with the US Public Company Accounting Oversight Board ("PCAOB"), we undertook joint inspections at PricewaterhouseCoopers LLP and Ernst & Young LLP in 2011/12.

### 3.8 Input to standard-setting process

An important consequence of our work, we gain an overall understanding of how firms are interpreting and applying the requirements of both the Auditing and Ethical Standards, and therefore are able to recommend changes to the standard-setters which we believe would enhance overall audit quality or safeguard auditor independence.

In this respect we continue to work closely with the FRC's Codes and Standards Division and provide regular feedback on issues arising from our inspections in relation to the interpretation and application of Standards.

In the coming year we expect to provide input to the FRC's responses to a number of International Auditing and Assurance Standards Board ("IAASB") consultations, including those relating to projects on audit quality, audit reporting and the implementation of Clarified ISAs.

### 3.9 Collaboration with the Financial Services Authority

A Memorandum of Understanding ("MoU") was entered into in 2011 with the FSA. The purpose of the MoU was to assist each body in the proper performance of its respective functions. It provides that we meet at least four times a year.

We have continued to meet on a regular basis with the Financial Services Authority to discuss areas of mutual interest. These discussions, which have focused primarily on bank and building society audits, have provided valuable input to our inspection process. We have also provided the FSA with details of the findings from those 2011/12 reviews of interest to them. In our view these arrangements are working well and are of mutual benefit to each organisation.

### 3.10 Basis of funding

We form part of the FRC's Conduct Division and have a staff of approximately 20 full-time equivalents engaged in audit inspections. The direct costs of the inspection activities falling within our normal scope are funded by the relevant professional accountancy bodies. Inspection activities outside our normal scope, such as those relating to public sector bodies and the auditors of Crown Dependency entities, are subject to separate funding arrangements designed to recover in full the costs of these inspections.

# Appendix A

## Inspection process and basis of reporting

### Inspection process

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor firms' compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors 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 inspections or, in relation to the reviews of individual audits, those effective at the time the relevant audit was undertaken.

Our inspections of the major firms comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year. The scope of our inspections for 2011/12 is set out in appendix B.

Our inspections of firms auditing ten or fewer entities within our scope are limited to a review of the quality of selected audits of listed and other major public interest entities that fall within our scope of inspection.

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 our independent inspection but within the scope of audit regulation in the UK. Their work 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. They also review the policies and procedures supporting audit quality of those firms auditing ten or fewer entities within our scope.

Our review of the policies and procedures supporting audit quality of major firms covers the following areas:

- Tone at the top
- Transparency reports
- 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

Our reviews of individual audit engagements and policies and procedures supporting audit quality of major firms cover, but are not restricted to, compliance with the requirements of relevant standards and other aspects of the regulatory framework. Reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.

We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree action plans with the firms designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified requiring action by the firms than areas of strength and are not intended to be a balanced scorecard or rating tool. We also assess the extent to which each firm has addressed the findings arising from our previous inspection.

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

When reviewing individual audits, we do not carry out a detailed technical review of the financial statements. Such reviews are the responsibility of the FRC's Financial Reporting Review Panel ("FRRP"). Our focus in relation to financial reporting issues is on the appropriateness of audit judgments exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Accounting and disclosure issues identified are therefore raised with firms in an audit context rather than a financial reporting context. However, we challenge audit judgments on financial reporting issues, where appropriate, as an integral part of our work.

If we consider there is sufficient doubt as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, we may draw the matter to the attention of the FRRP. The FRRP considers such matters in accordance with its operating procedures.

Similarly, if during the course of our inspections we identify a significant concern as to the conduct of an individual or firm relevant to the public interest, we may draw the matter to the attention of the FRC's Accountancy and Actuarial Discipline Board ("AADB") or recommend that the matter be investigated by the relevant professional body. The AADB or the professional body concerned will then determine what, if any, action to take in relation to the matter.

We share certain information obtained through our inspections with the FRRP and the AADB where relevant to their respective responsibilities. Information sharing arrangements with the FSA are discussed in section 3.9.

## Basis of reporting

We provide the Audit Registration Committees of the relevant professional accountancy bodies in the UK with a private report on our inspections at each major firm registered by them to conduct audit work.

The private reports to the Audit Registration Committees contain our findings relating to safeguarding or improving audit quality, together with an overall recommendation on whether the firm's audit registration should be continued. These reports form the basis of our public reports on each major firm.

We also issue private reports to the Audit Registration Committees on the significant findings arising from our review of individual audits undertaken by firms auditing ten or fewer entities within our scope together with an overall assessment of the quality of the audit.

We exercise judgment in determining those findings which are appropriate to include in our public reports, 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 on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audited entities.

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 before our private and public reports are finalised. As a result, there may be a significant period of elapsed time between completion of our inspection fieldwork at firms and the publication of reports on the inspection findings.

We also issue confidential reports on individual audits reviewed during an inspection which are addressed to the relevant audit engagement partner or director. Firms are expected to provide copies of the reports to the directors or equivalent of the relevant audited entities.

# Appendix B

## Scope of inspections 2011/12

Audits of the following entities were within the scope of inspections in 2011/12.

- All UK incorporated companies with listed equity and / or listed debt.
- AIM or Plus-quoted companies incorporated in the UK with a market capitalisation in excess of £50 million.
- Unquoted companies, groups of companies, limited liability partnerships or industrial and provident societies in the UK which have Group turnover in excess of £500 million.
- UK incorporated banks not already included in any other category.
- UK Building Societies.
- Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members.
- Charities with incoming resources exceeding £100 million.
- Friendly Societies with total net assets in excess of £1,000 million.
- UK Open-Ended Investment Companies and UK Unit Trusts managed by a fund manager with more than £1,000 million of UK funds under management.
- Mutual Life Offices whose "With-Profits" fund exceeds £1,000 million.

UK incorporated companies do not include those incorporated in the Crown Dependencies of Jersey, Guernsey or the Isle of Man.

The above criteria were applied as at the start of the period in identifying entities within the scope for our 2011/12 inspections. Further details relating to our scope of inspections, including the criteria applied for the 2012/13 inspections, is available on the FRC's website.







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