Financial Reporting Council

April 2014

Baker Tilly UK Audit LLP

Audit Quality Inspections

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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 Baker Tilly UK Audit LLP ("Baker Tilly" or "the firm") carried out by the Audit Quality Review team of the Financial Reporting Council ("the FRC"), in respect of the period to 31 March 2014 ("the 2012/14 inspection"). Our inspection was conducted in the period from May 2013 to September 2013 (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 six audit engagements undertaken by the firm, including a further review of an audit reviewed in our last inspection for 2010/12. These related to listed and other major public interest entities[1], with financial year ends between 25 March 2012 and 31 December 2012. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit. The further review included an assessment of the extent to which our previous findings on this audit had been addressed.

Our responsibility is to monitor and assess the quality of the audit work performed by the UK firm. Accordingly, our reviews of group audits covered the planning and control of the audit by the group engagement team, including their evaluation of the adequacy of the work performed by component auditors, and selected aspects of other work performed by the UK firm at group and/or component level. Our reviews do not cover the audit work relating to components audited by Baker Tilly International network firms.

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

[1] As defined by the FRC's Audit Quality Review 'Scope of Independent Inspections 2013/14'

- Other firm-wide matters

We exercise judgment in determining which findings 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 any areas of particular focus in our overall inspection programme for the relevant year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.

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 in response to some of our findings by the date of this report. We will review the adequacy of the actions taken and planned during an interim inspection in 2015.

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 Baker Tilly in the conduct of our 2012/14 inspection. However, the firm has been reluctant to accept some of the conclusions we have drawn from the findings of our file reviews which may inhibit it from determining how the required improvements in audit quality can be achieved.

1.2. Background information on the firm

The firm is a limited liability partnership. At the time of our inspection non-audit services are provided through three separate LLPs and other trading entities, covering tax, accounting and advisory, corporate finance, restructuring and recovery services. The Baker Tilly Group (comprising four LLPs and other trading entities) is the UK member of Baker Tilly International, described as a global network of independent firms.

For the year ended 31 March 2013, the firm's turnover, relating to audit work and other assurance services, was £55.5 million. The firm operated through 22 offices in the UK with a total of 91 partners, of whom 86 were authorised to sign audit reports, and 24 employees (audit directors) who were authorised to sign audit reports[2].

We estimate that the firm audited 31 UK entities within the scope of independent inspection as at 31 December 2012. Of these entities, our records show that 12 had securities listed on the main market of the London Stock Exchange.

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 inspected by us under separate arrangements agreed

[2] As disclosed in the annual return to ICAS as at March 2013.

with the relevant regulatory bodies in those jurisdictions. Our records show that, at the time of our inspection, the firm had no such audits.

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 prior year inspection.

The firm places emphasis on its overall systems of quality control and, in many areas, has appropriate policies and procedures in place for its size and the nature of its client base. However, we have identified certain areas where improvements are required to those policies and procedures. We remain concerned that, in some areas, action taken by the firm in response to our prior findings has not adequately addressed the issues previously identified. 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 firm places more emphasis than other firms on obtaining audit evidence through analytical review procedures, rather than through other substantive testing. However, these analytical procedures continue not to be performed well on a consistent basis by audit teams, despite additional training provided by the firm. Given the emphasis the firm is placing on this approach, we are concerned that we continue to identify issues in relation to the quality and robustness of the audit evidence obtained on most audits reviewed.

1.4. Key messages

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

- Review the firm's audit methodology in the light of the continuing deficiencies identified in the performance of analytical review procedures.
- Ensure that the firm's risk assessment procedures take proper account of the nature of the audited entity and the planned level of reliance on controls, particularly where there is high reliance on IT systems and controls, and that appropriate evidence is obtained to support the assessments.
- Ensure the firm takes more timely and effective action in response to internal and external audit quality monitoring findings.
- Put greater emphasis on audit quality feedback in partner appraisals and ensure that specific objectives are set to achieve measurable improvements in audit quality.
- Continue to improve the firm's arrangements for promoting compliance with Ethical Standards.

2. Principal findings

The comments below are based on our reviews of individual audits and the firm's policies and procedures supporting audit quality.

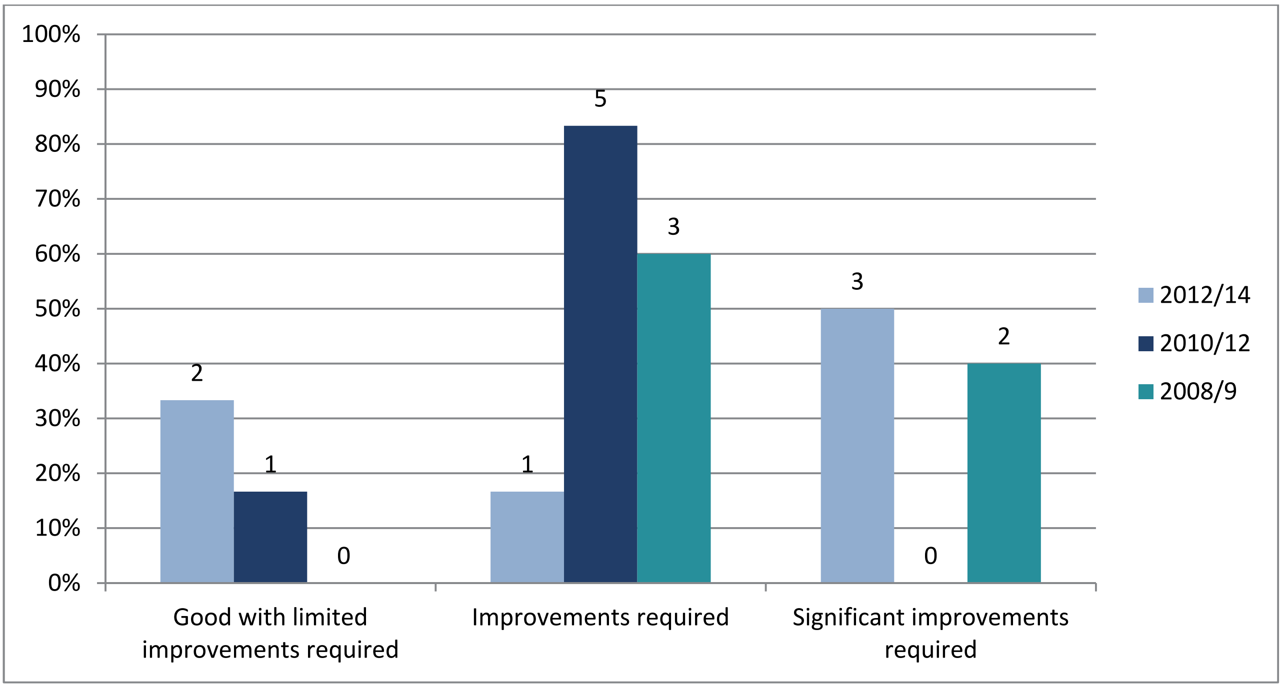
2.1. Reviews of individual audits

We reviewed and assessed the quality of selected aspects of six audits (2010/12: seven audits), of which one was a further review of an audit reviewed in our last inspection which included an assessment of how findings previously raised had been addressed (2010/12: one follow-up review was undertaken).

Two of the audits we reviewed (2010/12: one) were performed to a good standard with limited improvements required and one audit reviewed (2010/12: five) required improvements. Three audits required significant improvements in relation to one or more of the following: the performance of substantive analytical review procedures; the audit of impairments; the reporting of audit differences arising on the audit of the valuation of interest rate derivatives; the audit of IT general controls; and the consideration of the level of overall financial statement risk. Further details are set out below.

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 significant audit judgments in the areas reviewed 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 2012/14 falling within each grade, with comparatives for 2010/12 and 2008/09.



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 and the scope of the individual reviews. For this reason, and given the 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.

Whilst the firm promotes a commitment to audit quality, audit teams generally focused on explaining why the audit work performed in specific areas was acceptable rather than the improvements that should be made. As a result we are concerned that, despite additional correspondence with the firm on the issues arising, the firm may not have accepted certain of our findings that led us to conclude that significant improvements are required on three of the audits that we reviewed. Whilst action has been or is being taken on certain points raised, the firm needs to recognise the importance of audit teams being more responsive to AQR findings to determine at an earlier stage of the review process the action required to address deficiencies identified in relation to an audit, in order to achieve the necessary improvements in audit quality on a timely basis.

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 following findings which the firm should ensure are addressed appropriately in future audits.

The significance of these findings in the context of an individual audit reviewed, and, therefore, the implications for our grading of that audit, will vary. However, even where our overall assessment of an audit was that the improvements required were limited in nature, we may nevertheless include the relevant findings in this report if we consider them important in the broader context of improving audit quality at the firm.

In response to our prior year findings, the firm took a number of steps to make improvements to audit quality. Additional training and new audit templates were provided to audit staff in relation to substantive analytical review, IT general control testing and journal testing. While these steps are helpful, issues nevertheless continued to arise in the areas noted below. The firm should, therefore, review the adequacy of its response in these areas and how effectively changes are being implemented by audit teams. The firm's rate of progress in achieving improvements in audit quality, particularly in relation to substantive analytical review and the audit of IT systems, has been slower than we expected. We believe that some changes to the firm's methodology, as discussed below, would help to ensure that audit teams are able to execute it to the required standard on a consistent basis.

Substantive Analytical Review

The firm's audit methodology places significant emphasis on the performance of substantive analytical review procedures, which the firm mandates on all audits. Despite the additional training provided by the firm to staff, we have not seen significant improvement in the overall quality of audit evidence obtained from these procedures in the audits we reviewed. The procedures performed for certain transactions and account balances were inadequate, in some or all of the areas noted below, in four of the audits reviewed:

- Inappropriate expectations were set (certain aspects of all four audits).
- A lack of corroboration of explanations for significant variances (aspects of two audits).
- A lack of disaggregation of the balances being tested (aspects of two audits). In one of these cases the lack of disaggregation meant that variances on different transaction streams were netted and it was, therefore, concluded that no further work was required. If considered separately, however, further work to investigate the variances should have been performed.
- Insufficient or no audit procedures were performed over the reliability of the data produced by the entity and used in the substantive analytical review to both develop expectations and corroborate explanations for variances (aspects of three audits).
- In one audit the results of an analytical review performed in respect of a particular revenue stream, which relied heavily on data produced by the entity's systems, were considered by the audit team to be "exceptional", and as a consequence no further audit procedures were performed. The firm's methodology defines analytical review findings as 'exceptional' if they are so persuasive that the risk of material misstatement is reduced to negligible levels and audit teams are required to record an explanation for reaching this conclusion. The audit team had not obtained sufficient evidence of the reliability of the entity-produced data used in the analytical review and had not recorded why it reached the conclusion that the analytical review was 'exceptional'.

The following case illustrates the risks of placing too much reliance on obtaining audit evidence through analytical review and the importance of the underlying risk assessment. A review of one audit in our prior inspection raised concerns about the analytical review procedures performed over accruals and that no other substantive audit procedures had been undertaken. Although not consistent with their documented risk assessment, the audit team had explained that they considered accruals to be a low risk balance so that, under the firm's methodology, audit evidence could be obtained principally from analytical review procedures, with no detailed substantive testing required to be performed. However, in the subsequent year it was discovered that a number of the accruals were unsupported and a material adjustment relating to the prior year had to be made. Relying on substantive analytical procedures, which were not performed well, as the main source of audit evidence may have contributed to this material misstatement in accruals not being identified in the prior year.

Analytical review can be a valuable substantive audit procedure. However, as it principally involves following-up variances from expectation, it requires realistic and precise expectations to be set; high confidence in the data used to generate the expectations; and rigorous verification of variances. In practice, our findings show that these conditions are not always being met by audit teams in applying the firm's methodology, possibly because the policy of mandating analytical review on all audits leads teams to use it in circumstances where it is unlikely to be effective. The firm's procedures allow a departure from this policy if the engagement partner considers that the audit objective could be achieved in a better way and obtains the prior approval of National Audit Technical. While we understand the rationale for this, it may act as a barrier to the adoption of more effective audit approaches in specific cases. Further, where errors or misstatements cause actual results to be in line with expectations, analytical review is unlikely to be effective, which illustrates the risk of over-reliance on this approach.

The emphasis placed by the firm on the use of analytical review procedures to obtain audit evidence, coupled with the continuing deficiencies in their performance in practice, are likely to have significant implications for the overall adequacy of the audit evidence obtained in particular areas. Given this, and the limitations inherent in this approach discussed above, the firm should both review the level of reliance on analytical review within its audit approach and take further action to improve significantly the quality of the analytical review procedures performed. In future inspections, we will expect to see substantive analytical review procedures, on which reliance has been placed, being executed to the required standard on a consistent basis.

Assessment of financial statement audit risk

The firm's methodology requires audit teams to answer a series of questions to reach an assessment of the level of financial statement audit risk as high, medium or low. Where the level of risk is assessed as low, less audit evidence is required to be obtained. In particular, if the level of risk for the transaction or balance being tested ('item risk') is also assessed as low, audit evidence can be mainly obtained from analytical review procedures. In one audit, we considered that it was not appropriate to assess the financial statement audit risk as low for a regulated entity, trading exclusively through the internet, with rapid growth and significant reliance on IT systems. This resulted in an audit approach, for transactions or balances assessed as low risk, which relied heavily on analytical review procedures, without sufficient consideration being given to the need for controls testing to be undertaken.

General IT controls

In three audits we reviewed the audit work performed in relation to general IT controls. In these audits, the controls were not sufficiently tested; either the sample sizes were below that required by the firm's methodology, or the controls were 'tested' through discussion only. Further, in all cases where general IT control weaknesses were identified, there was a failure to consider either performing further audit procedures or reporting control weaknesses to management and the Audit Committee.

Controls testing

In three audits, the audit plans did not identify which assertions the controls to be tested covered or how the controls being tested would mitigate the risk identified. In some key areas controls were tested at an individual transaction level only. The firm's guidance directs teams to test at an individual transaction level which means that teams do not sufficiently consider whether there are controls operating over a series of transactions which may be tested to provide a greater level of audit evidence.

Journal testing

We reviewed the work performed on journals on four of the audits reviewed. On one audit there was a lack of evidence of the journals that had been tested and on another audit no procedures were performed over the completeness of the journals. On two audits testing of journal entries was not performed. In both of these cases, the audit teams explained that audit evidence on journals had been obtained from analytical review of the relevant account balance. However, such procedures may not identify journals posted by management to ensure actual results met budgeted results and where there are no significant variances to investigate. It is, therefore, not appropriate to rely on this work in response to the risk of management override of controls, which further illustrates the risks of over-reliance on analytical review procedures. The firm issued new guidance to audit teams which mandates that journals be tested; it should continue to monitor how well this guidance is being implemented by teams.

Audit of directors' valuation

In one audit, the directors used the current quoted 15 year swap rate to value an interest rate swap liability. This produced a valuation which was materially different from the valuation provided by the counterparty bank, which used the 3 month LIBOR swap curve. The audit team engaged the firm's expert to determine a range and the directors' valuation was below that range. No further work was performed to establish why the directors' valuation was below the valuation range calculated by the firm's expert. The difference between the lowest point of the firm's expert's range and the directors' valuation was material and should have been included on the schedule of unadjusted audit differences reported to the Audit Committee. Further, there should have been a proper link between the conclusions of the auditor's own expert and the basis for the auditor's opinion.

Impairments

In one audit, the audit team did not request management to prepare an impairment review to support management's assertion that no impairment provision was required. In a further audit, management did not provide the impairment review requested by the audit team to support their assertion that no impairment provision was required. In another audit, the audit team performed the sensitivity analysis that should have been performed by management. Audit teams should inform or remind management, as necessary, of their responsibility to prepare information to support the impairment conclusions reached. Where management do not provide the necessary information, this should be reported to the Audit Committee.

Provision of payroll services to listed entities

For one AIM listed audited entity we identified that the firm was providing payroll services to a subsidiary in breach of the requirements of Ethical Standards. The firm had provided these payroll services to the entity for a number of years and prior to its listing in 2011. At the time of the listing the firm should have reviewed all of the non-audit services being provided to the entity and ceased those services which are not permissible for a listed entity. On discovery of this matter, the firm took prompt action to cease providing payroll services to this entity. The firm have subsequently reviewed the non-audit services provided to listed audited entities and their subsidiaries and have confirmed to us that no other prohibited services are provided.

Audit of disclosures

Our reviews identified disclosure errors or omissions that had not been identified by the audit team concerning related party transactions, dividends and segmental disclosures (one audit in each case). In addition, in one audit, there was a lack of audit evidence to support the related party disclosures made. The firm's internal quality control processes should have identified these matters before the audit reports were issued.

Other findings

Reporting to Audit Committees

We considered the sufficiency, quality and timeliness of the firm's reporting to Audit Committees on all the audits we reviewed and identified two aspects requiring improvement.

In all audits reviewed, there was no evidence that the audit team had asked the Audit Committee to correct unadjusted misstatements, as required by Auditing Standards. The firm's Audit Committee reporting template did not include a request that unadjusted misstatements be corrected in finalising the financial statements. For all audits, the significant risks identified were reported to the Audit Committee. However, the risk of management override of controls, which is presumed to be a significant risk on all audits under Auditing Standards, was not identified and reported as a significant fraud risk on any of the audits reviewed.

2.2. Review of the firm's policies and procedures

The firm's policies and procedures and audit methodology and software are developed in the UK. The firm's overall strategy for the next three years targets audit quality, audit profitability and profitable growth. Emphasis is given in training material to the quality of the firm's work and to increasing efficiency on audits to improve profitability. Audit quality matters are communicated to partners and staff regularly through a network of individuals at each office responsible for promoting audit quality (Audit Quality Champions).

In September 2013 the Baker Tilly Group acquired the majority of the business of RSM Tenon after RSM Tenon Group plc was put into administration. The audit firm has therefore increased by approximately 50%, resulting in a firm with around 1,000 audit partners and staff and 35 offices. The firm put plans in place to ensure the transferred partners and staff were trained in the firm's audit methodology and software by 31 March 2014, and that they achieved appropriate audit quality standards. The implementation of these plans, and the firm's monitoring of their success in achieving and enhancing audit quality, will be assessed during our next inspection.

Improvements made during the year

The firm took action to address our prior inspection findings and improve its procedures where it considered it necessary to do so. In particular, an Ethics Toolkit, encompassing the Ethical Standards and the firm's guidance in one place, has been implemented and training provided to all staff. This includes clearer guidance to partners as to when they should consult the Ethics Partner. The firm's ethics consultation log demonstrated, in a number of cases, that the firm was dealing with ethical matters appropriately. This included resigning from an audit where the threats arising from a business relationship were assessed as high and refusing audit partners' requests to join an audited entity within two years of leaving the firm.

In addition, a new fully computerised Client and Engagement Acceptance Programme (CEAP) has been implemented which automatically prompts a need for certain approvals to be obtained.

Prior year findings not adequately addressed

The firm has taken action in response to most of our prior year findings. However, there are a number of areas where our prior year findings have not been adequately addressed, as set out below.

Financial statement audit risk assessment

The audit team completes a questionnaire which is scored to reach an assessment of an overall level of financial statement audit risk which affects both the audit approach and the extent of testing required. The majority of the firm's audits continue to be assessed by audit teams as low risk and, as a consequence, a lower level of audit evidence is required to be obtained. We are still not convinced that, in applying the system, all of the firm's audits that should be assessed as higher risk are identified as such. As reported above, on one audit reviewed we considered that this risk level had been inappropriately assessed as low.

Training and professional development

The firm has improved the procedures in place to monitor partner and staff attendance at mandatory courses. Non-attendees are now identified and requested to read the course material but confirmations that this has been done are not required. The firm's monitoring processes in this area require some further improvement.

Performance evaluation and remuneration

As in previous inspections, from discussions with the firm's senior management it was possible to identify some link between audit quality indicators and changes to the overall remuneration package for an individual partner. The firm also explained that there were a few cases in the period where it had withdrawn a partner's authorisation to undertake some or all types of audit engagement as a result of poor audit quality findings. However, in one case, the appraisal form for an audit partner, who received a modest remuneration increase, made no reference to two adverse findings from the firm's audit quality monitoring and showed the highest grade for technical skills, which includes considering the findings of audit quality monitoring. The significant findings related to both non-compliance with the firm's policies and with Ethical Standards and these were reported to National Audit Technical and the Ethics Partner. As these audit quality findings were not included in the appraisal documentation there was a lack of linkage, in this case, between audit quality and remuneration.

Most partner appraisal forms reviewed did not include specific feedback on audit quality and the audit quality objectives set were not sufficiently specific in nature. Partner appraisal documentation should include appropriate audit quality feedback, linked to appraisal gradings, with specific objectives set.

The firm is reviewing its partner appraisal and remuneration policies and should ensure that there is a more demonstrable linkage between audit quality indicators and partner remuneration.

Timeliness of response to significant concerns arising from audit quality monitoring

Significant concerns identified by the firm's audit quality monitoring process are reported to the National Audit Technical department. In response to our prior year finding the Quality Assurance Department produce a monthly report to the Audit Management Team showing individuals and offices under special scrutiny and the actions being taken, with any apparent delays highlighted. However, we identified two cases where the appropriate action had not been taken on a timely basis following the identification and reporting of audit quality issues. In both cases, the firm had prepared the financial statements for an unlisted entity and consideration was needed as to whether the financial statements should be reissued by the audited entity.

In one case, the disclosure of borrowings may have been incorrect and, in the other, small company financial statements had been filed inappropriately. In the first case, the audit team confirmed eight months later that the disclosures were correct and no action was needed. In the second case, the audit team confirmed ten months later that they had not made the required report to National Audit Technical on a timely basis and this matter would now be dealt with in the following year's financial statements. The firm's audit quality monitoring process should have ensured that the audit partner completed the required actions on a timely basis.

Current year findings

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

Risk assessment at the account balance and class of transaction level

The firm's methodology allows the risk relating to specific account balances and classes of transactions ('item risk') to be assessed as low where, inter alia, any error is unlikely to be material in total. Under the firm's methodology, where financial statement audit risk is also assessed as low, audit evidence for low item risk balances and transactions may be mainly obtained from analytical review procedures. In practice, this approach is frequently adopted, as financial statement risk is assessed by audit teams as low risk on the majority of the firm's audits.

The assessment of item risk should be made without reference to any reliance to be placed on internal controls or the level of automated processing. However, in practice we found cases where audit teams were assessing items as low risk where this is likely to be the case only if reliance can be placed on internal controls. This means that audit teams are only performing substantive audit procedures, often comprising mainly analytical review, even though they have in fact implicitly relied on the effective operation of internal controls. Where reliance is being placed on controls, and where there is a high level of automated processing with no manual intervention, substantive procedures alone may not provide sufficient audit evidence to support the firm’s audit opinion and controls testing might therefore be required to be performed.

The firm needs to review its risk assessment procedures, including the weight that may be given to such an assessment if it is not supported by tests of internal controls; the type of supporting evidence that is required; and the extent to which substantive analytical review is an appropriate audit response.

Accounting services provided to audited entities

The firm's audit quality monitoring identified five instances where the firm was providing accounting services to non-listed audited entities without completing the firm's Client and Engagement Acceptance Programme (CEAP) and without appropriate safeguards, as required by Ethical Standards. The failures to implement appropriate safeguards were communicated to the Ethics Partner and the firm provided additional training across all service lines to improve compliance with CEAP.

Major audits not treated as listed entities

For unlisted entities which are major audits within the scope of independent inspection, the firm's policies require the audit partner to consider whether they should be treated as listed entities. If so, the additional requirements under Ethical Standards applicable for listed entities are applied to these entities. If the audit partner considers it inappropriate for such an entity to be treated as listed, the partner is required to submit a written justification for consideration by the Board of Baker Tilly UK LLP.

For one unlisted entity, the written justification submitted to the Board did not, in our view, adequately consider all of the public interest considerations involved.

Staff secondments to audited entities

The firm’s ethics consultation log included two consultations relating to the secondment of the firm's staff to an audited entity. The supporting information did not adequately set out the details provided to the Ethics Partner to assist him in reaching a conclusion as to whether the proposed secondment was in compliance with Ethical Standards (which only permit the firm’s staff to be seconded to an audited entity for a ‘short period of time’). In particular, the planned length of the secondment was not set out in one case and, in the second case, the secondment was extended beyond the period set out in the original consultation. The firm has no policy in place as to what constitutes a 'short period of time' and, therefore, when partners might need to consult with the Ethics Partner.

Further a loan staff assignment to an audited entity, which was extended to exceed six months, was not included in the Ethics Partner consultation log. There was no evidence of consultation with the Ethics Partner regarding the acceptability of the secondment to this audited entity at either the inception or when it was extended.

Audit partners remaining as relationship partners

The firm's audit quality review for a listed entity identified that the audit partner had rotated after five years, but had remained responsible for the firm's relationship with the audited entity. The firm reviewed all of the listed (and deemed listed) entities which it audits to identify any other such cases. In total, eight cases were identified and action was taken to change the relationship partner where necessary. Where audit engagement partners rotate off, but continue in a relationship role, this is in breach of Ethical Standards.

Annual appraisals

In the sample we reviewed, three audit partner appraisal forms made reference to the selling of non-audit services to audited entities. In these cases, the partners appeared to believe that they would get credit for their success in selling non-audit services to entities they audited. Ethical Standards do not permit audit partners to be rewarded for selling non-audit services to audited entities.

The firm informed us that these references were not taken into account when evaluating performance or making remuneration decisions for these individuals. However, a perception is likely to be created that they will get credit if the inclusion of this material in the appraisal documentation is not challenged (and there was no evidence of such challenge). Any such references in appraisals should be challenged by those conducting the appraisal.

Other matters

Transparency report

We reviewed the firm's transparency report for the year to 31 March 2013, which was published in June 2013, to assess whether the information in the report was consistent with our understanding of the firm's quality control and independence procedures.

The firm appointed the firm's Ethics Partner and a retired partner of the firm as Independent Non-Executives. The firm's Transparency Report sets out the firm's view as to why the Ethics Partner is well-placed to perform an Independent Non-Executive role within the firm. However, we do not consider the firm's Ethics Partner to be an Independent Non-Executive, as he is neither independent nor non-executive within the definitions set out in the Audit Firm Governance Code ("the Code"). As a consequence, the Transparency Report should have stated that the appointment of the Ethics Partner to this role is not in compliance with the Code.

Following the firm's three year review of the arrangements in place, it has set up a new Public Interest Committee, chaired by the Ethics Partner, to which it has appointed a new Independent Non-Executive in addition to the retired partner Independent Non-Executive, who is continuing in post.

The firm's Transparency Report states that all partners must complete an appraisal form which includes a section detailing any feedback from the firm's quality monitoring process. However, this did not appear to be consistent with most of the sample of partner appraisals we reviewed.

We did not identify any further inconsistencies with our understanding of the firm's quality control and independence procedures.

Andrew Jones

Director

Audit Quality Review

FRC Conduct Division

April 2014

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 supporting audit quality 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 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 our 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 for review and cannot be relied upon for this purpose.

The professional accountancy bodies in the UK register firms to conduct audit work. Their monitoring units 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 our public report on each inspection, taking into account their relative significance in relation to audit quality, in the context of both the individual inspection and any areas of particular focus in our overall inspection programme for the year. We have generally reported our findings by reference to important matters arising on reviews of individual audits and, where appropriate, themes arising or issues of a similar nature identified across a number of audits reviewed.

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 are 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 rigorous quality control procedures are applied. These procedures include a peer review process at staff level and a final review by independent non-executives who approve the issue of all reports. These processes are designed to ensure both a high quality of reporting and that a consistent approach is adopted across all inspections.

We also issue confidential reports on individual audits reviewed during an inspection. While these reports are addressed to the relevant audit engagement partner or director, they are copied to the chair of the relevant entity's audit committee (or equivalent body).

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

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2 April 2014

Dear Sirs

2012/14 Audit Quality Inspection Report

We are committed to achieving the highest standards of audit quality and we continue to take whatever actions are necessary to do this.

We welcome the Audit Quality Review Team's report and we are already addressing all of the findings that will contribute to an improvement in audit quality.

Our Transparency Reports provide more details of our commitment to quality and are available on our website at www.bakertilly.co.uk.

Yours faithfully

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