



# **BDO LLP**

## **AUDIT QUALITY INSPECTION**

**JULY 2019**

---

# The FRC

Our mission is to promote transparency and integrity in business.



We have responsibility for the public oversight of statutory auditors.

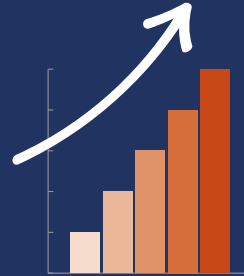
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



# AQR

We monitor the quality of UK Public Interest Entity audits.

+1.55	0.20%	+2.27%	-11.48%	POS	-3,2320
+1.20	0.21%	+2.83%	-15.93%	NEG	-3,9993
+3.65	0.14%	+2.42%	-17.67%	POS	-4,2421
+5.38	0.27%	+2.19%	-18.32%	NEG	-4,2083
+5.32	0.27%	+2.28%	-14.73%	NEG	-3,5708
+5.10	0.20%	+2.76%	-20.12%	NEG	-2,8339



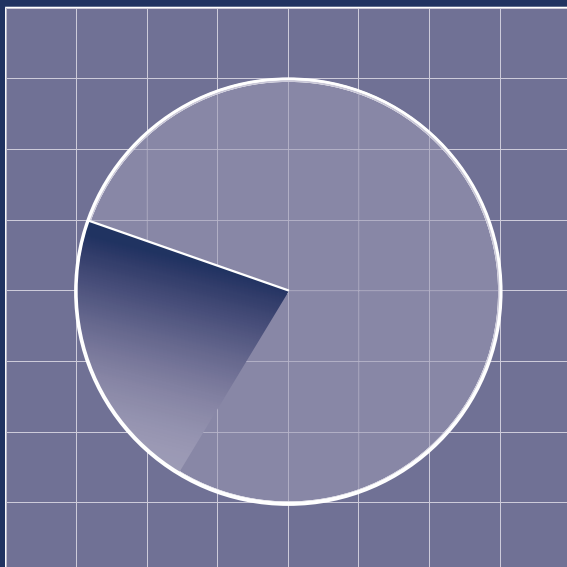
We promote continuous improvement in audit quality.

Our team of over 40 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



# The Firm

BDO LLP has 139 audits within the scope of AQR inspection, including 4 FTSE 350 audits.



# Our inspection process

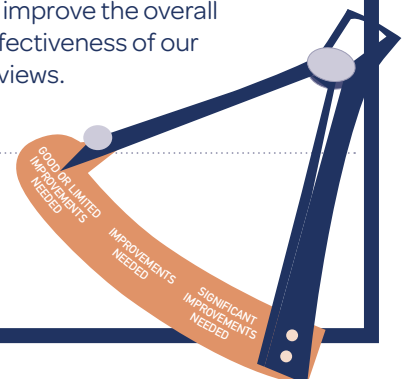


There are around 2300 audits within the scope of AQR inspection. In total, we inspected 160 individual audits in 2018/19, including 8 at BDO.



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

We assess the overall quality of the audit work inspected.



# Financial Reporting Council

## BDO LLP

### Audit Quality Inspection

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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

## Contents

<b>1</b>	<b>Overview</b>	<b>5</b>
<b>2</b>	<b>Key findings requiring action and the firm's response</b>	<b>9</b>
<b>3</b>	<b>Good practice examples and developments in the year</b>	<b>12</b>

This report sets out the principal findings arising from the 2018/19 inspection of BDO LLP ("BDO" or "the firm") carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted this inspection in the period from February 2018 to February 2019 ("the time of our inspection"). We inspect BDO, and report publicly on our findings, annually.

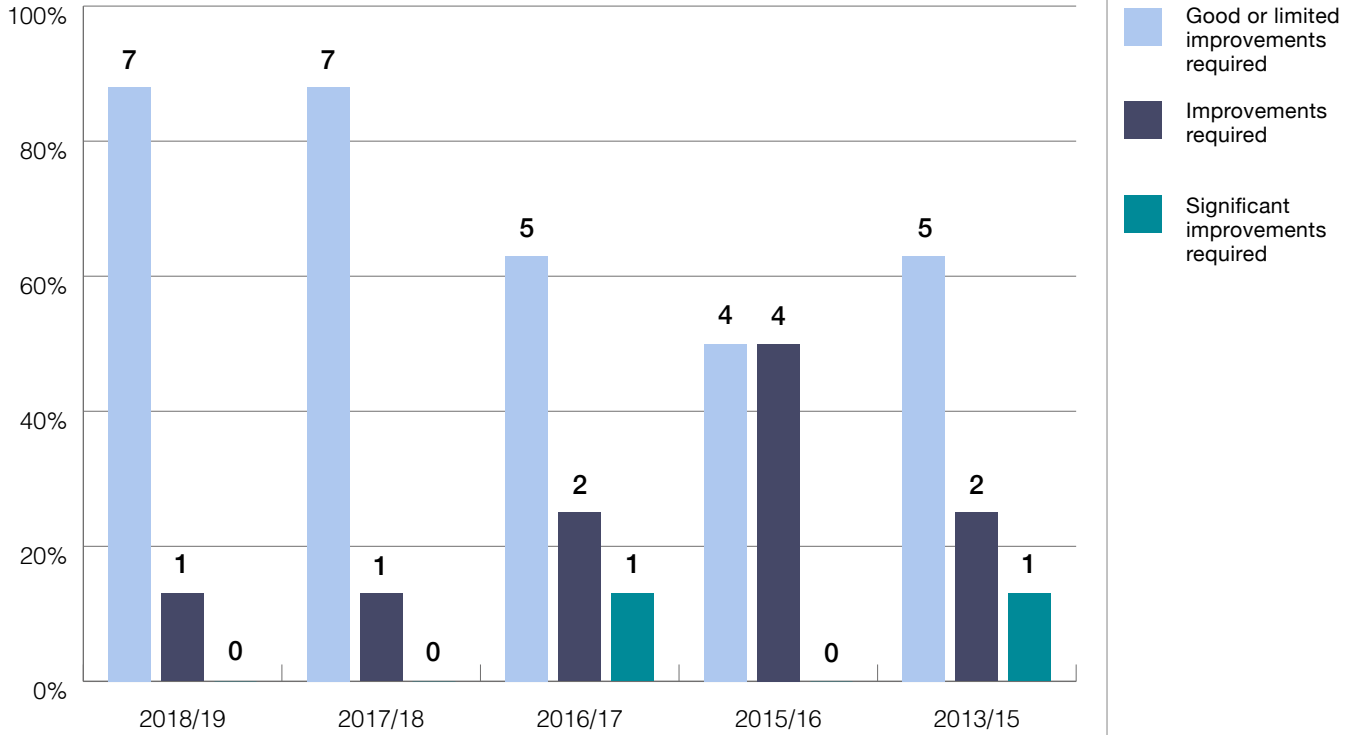
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality. This year, our firm-wide work, performed on a three year cycle, focused on internal quality monitoring, engagement quality control reviews and independence and ethics.

Our priority sectors for inspection in 2018/19 were general retailers; oil and gas producers; support services companies; and financial services. Of the 139 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: General retailers (11); Oil and Gas producers (7); Support services (13); and Financial services (34).

We also paid particular attention to the following areas of focus: changes in auditor appointments; audit of fair value investments (including goodwill impairment); the use of auditor's experts and specialists; and the audit of controls.

## Our assessment of the quality of audits reviewed

### BDO



Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our selections, which are primarily risk-focused, are also informed by the priority sectors and areas of focus referred to above. For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

---

## 1 Overview

The FRC set a target for the firms that at least 90% of FTSE 350 audits should be assessed as requiring no more than limited improvements by the end of the 2018/19 inspection cycle. Regrettably, no firm inspected this year achieved the target.

As a result, we will, for 2019/20:

- Continue to measure firms' audit quality against the 90% FTSE 350 target and expect all firms to meet that target.
- Extend the 90% target to all other audits within the scope of our inspection.

**Stakeholders rightly demand high quality work on all audits and they would expect, we believe, that all audits subject to our review should require no more than limited improvements. We will therefore, for 2020/21 onwards, set a new target for audit firms that 100% of audits should require no more than limited improvements.**

All the firms reviewed have performed root cause analysis and identified a number of themes relating to why the audits we inspected did not always meet the required standard and why certain findings recur over a number of years. These themes, across the firms inspected, include insufficient scepticism and weaknesses in project management or resourcing. In addition, the analysis also highlighted inconsistent execution of firms' audit methodologies and quality control procedures. Firms' actions should be targeted and responsive to the findings from their root cause analysis to achieve the required improvements in audit quality.

We will continue to take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past two inspection cycles, we have referred 16 audits, across all firms inspected, to the Case Examiner for consideration of further enforcement action. In these cases, we further scrutinise the root cause analysis undertaken by the firm and the actions taken by the firm in response to our findings and consider what additional action we can take to ensure audit quality.

### Key findings for BDO

The overall results of our reviews of the firm's audits show that seven out of eight audits reviewed were assessed as requiring no more than limited improvements, the same as in 2017/18.

Our key individual review findings related principally to the need to:

- Strengthen audit procedures relating to the timing of revenue recognition.
- Improve the evidence of appropriate challenge in relation to valuation judgements.

---

We have no significant findings arising from our firm-wide work on internal quality monitoring, engagement quality control reviews and independence and ethics.

We note that some of the firm's agreed actions relating to our independence and ethics findings are ongoing and their completion should remain a key focus for the firm.

Given our key individual review findings noted above, this would indicate that the firm's quality control procedures have not been sufficiently effective to achieve the necessary improvement in audit quality.

Further details of our key findings are given in section 2, together with the firm's actions to address them.

### **Good practice identified and developments in the year**

We identified examples of good practice in the course of our work, including group audits and the use of data analytics. These, together with firm developments in the year, are set out in section 3.

### **Root cause analysis**

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

The firm has performed RCA in respect of our key findings and considered the outcome in developing the actions included in this report. We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques further.

Given that no firm this year has met the FTSE 350 target, firms need to re-appraise whether their RCA accurately identifies the causes of our inspection findings and whether their actions are properly linked to those causes. In particular, the firms should increase their focus on systemic issues behind the findings as well as the findings on each individual audit.

## Firm's overall response and actions:

We are pleased with the results of the FRC review in relation to the firm for 2018/19 but nevertheless we are not complacent and we fully recognise the importance of continuing to focus on improving the quality of our audits. Quality is a key focus for the firm and underpins our firm strategic principles. We believe that our continued investment in root cause analysis (RCA) is one of the key drivers of continuous improvement. In our AQR report last year (June 2018), we noted that we undertook RCA on our highest quality files. Based on the characteristics applying to a high quality audit we asked all offices and sectors within the audit stream to create and implement action plans to ensure these characteristics could be replicated on all files and we are starting to see the benefits of these actions, which we continue to monitor.

As noted by the FRC we have performed RCA on the two key findings in their report. In relation to the first finding '*Strengthen procedures in relation to the timing of revenue recognition*', we believe that whilst part of the cause relates to issue 2 (discussed below), the main root causes of the finding raised by the AQR was in relation to:

- A significant change in the finance team at the client resulting in the client not always being able to provide timely and precise responses to our queries, and
- Weak articulation and implementation of the planned audit strategy, which was not corrected through our review process.

In relation to the second finding '*Improve the evidence of appropriate challenge in relation to valuation judgements*' we acknowledge that we received a similar finding in our report last year. We have already undertaken a number of actions in this area (which we detailed last year) however, given the timing of these actions we will not yet have seen the full benefits reflected in audit files selected in this review cycle. However, we re-performed root cause analysis with the teams involved in order to ensure that there were no new causes arising.

Further root cause analysis of the issues provided more useful insights:

- As these are complex areas the reporting entity has not always formed their conclusions on the judgements at the planning stage of the audit hampering the team's ability to finalise the audit approach. This often led to changes to the proposed approach during the audit and it is key to ensure that the file demonstrates how the approach evolves over the course of the audit.
- As implied above these areas are invariably considered 'senior team' issues and more junior members of the team can feel that they do not have the required depth of knowledge to fully appreciate the issues and add a useful input resulting in a weakening of the preparation and review cycle.
- Continuity of staff on audit engagements contributes towards a higher quality audit strategy as cumulative knowledge can be used to create client specific test plans.

- 
- Given the level of judgement involved in these areas, it is vital that our audit evidence of the work done is clear and in sufficient detail to demonstrate the robustness of our challenge.
  - Following on from this point, where a highlights memorandum or similar summary schedule was not utilised by the teams it was not always easy for a reviewer to assess the conclusions reached in these areas at the end of the audit.
  - When documentation is not prepared contemporaneously with the work effort it becomes more challenging to ensure that the audit file is complete. As more judgemental areas are often some of the last to be completed, and often dealt with by the more senior members the quantum of documentation and speed of review can result in a reduction in the quality of that documentation.

Some of the areas above reinforce the findings we reported in our 2018 report, including specific behavioural factors, which contributed towards a high quality audit:

- Doing the right work at the right time – telling the story as it unfolds and as key decisions are made rather than purely summarising the final position.
- Involvement of senior team members in all areas and the importance of their influence on the audit and on the job training of other team members.
- Continuity of staff – members of the team building a good knowledge base about the client and their systems and using this to enhance audit work performed.
- High quality concise documentation telling the story of the audit.

We have identified a number of actions we are planning to undertake to address these issues in the relevant sections later in the report.

We will continue to use RCA to enable us to implement specific and tailored action plans to drive continuous improvements in audit quality.



---

## 2 Key findings requiring action and the firm's response

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

### Strengthen audit procedures relating to the timing of revenue recognition

Revenue is an important driver of a company's operating results and is often identified as a key performance indicator on which investors and other users of financial statements focus. Accounting for revenue recognition may be susceptible to manipulation, particularly where entities perform significant amounts of variable work. Audit teams should ensure that they have a clear and appropriate audit approach and have undertaken adequate procedures in these areas.

#### Findings

We reviewed the basis of revenue recognition on most audits inspected. On one audit the audit team did not obtain sufficient appropriate evidence that revenue was being recorded in the correct accounting period.

#### Firm's actions:

We note that the AQR reviewed revenue on most of the audits they inspected and highlight in section 3 some good examples of work on revenue. We acknowledge that it is a key area of any audit and improvements can always be made. As we noted above, the root causes of the issue identified by the AQR was in relation to specific circumstances surrounding this particular reporting entity and the audit team's response to those circumstances, which the team will address in future. However, they also highlight the importance of understanding the systems in place at the entity and understanding the revenue streams in terms of revenue recognition, fraud risk and creating a clear testing strategy. We therefore intend to undertake a number of actions in this area:

- As noted in our response to the finding below, implement standard summary schedules in key areas, which will include a summary of the strategy of revenue and assist in focusing the review process.
- Include a session in our annual AQR in scope forum to consider fraud risk factors in revenue recognition, which will include input from our forensics team.

---

## Improve the evidence of appropriate challenge in relation to valuation judgements

The valuation of many assets and liabilities requires the use of judgement in setting assumptions. These valuations can be sensitive to small changes in the assumptions used and may be susceptible to management bias. Auditors should therefore robustly challenge the reasonableness of management judgements and obtain appropriate audit evidence to corroborate the valuation decisions made.

### *Findings*

We reviewed the audit of asset valuations and provisions on most audits that we inspected, due to the level of audit risk related to these balances and their impact on the financial statements. We identified recurring findings across the audits reviewed relating to the challenge of management and corroboration of key assumptions. Specific examples include insufficient evidence or demonstration of challenge concerning:

- The level of provision applied to inventory and similar assets.
- The reasonableness of costs to complete for significant property developments, including those highlighted as impairment risks.
- Cash flow forecasts and related growth assumptions supporting management's impairment assessment.
- The volatility rate used by management to value share options.
- Completeness of contract provisions.

## Firm's actions:

As noted in our overall comments we have already taken a number of actions, which we detailed in our report from 2018. However, we believe there is more work to do and intend to undertake the following:

- Create mandatory templates for highlights memos and summaries of SRMMs, which will initially be used by AQR In scope/PIEs entities with a view to rolling out to all engagements. These will be used to tell the story of the audit, including challenges of management, not just record the final position reached.
- Consider whether a mid-audit Engagement Team Discussion (ETD) follow up would be useful to force a reconsideration of issues that were not resolved at planning to ensure the entire team is informed and able to consider how the changes to the SRMMs affect our audit approach and testing.
- Consider how the use of AQIs and management information from the next version of our audit tool, which is currently in pilot stage, can be utilised to help identify issues in relation to the timing of when work is performed and documented.
- We are already in the process of updating our Early in Career training to upskill attendees in the areas of auditing judgement and understanding ISA (UK) 540. This will include estimations, challenging management and performing analysis of sensitivities. We are also redesigning our existing templates for the new ISA (UK) 540 and provide additional education for audit teams in this area.
- Consider what training and guidance we may need to enhance or implement in relation to the audit of Tests of Controls (TOCs). In recent years, we implemented a successful suitability checklist to complete when planning to undertake Substantive Analytical Procedures (SAPs), which has caused huge improvements in the work performed in this area.
- Consider the central booking system for audit staff and identify any developments needed to optimise the ability to maintain continuity on audit engagements.

---

## 3 Good practice examples and developments in the year

### Good practice

We set out below the key areas where we noted good practice, either in audit work on individual engagements or firm-wide procedures.

#### Individual audit reviews

##### *The use of data analytics and coordination with IT specialists in the audit of revenue*

On some of the audits inspected, IT audit specialists were instructed to assist in the audit of revenue and related balances. We saw examples of data analytic procedures to confirm completeness of revenue being performed to a high standard.

##### *Group audit team's oversight of and involvement with component auditors*

Many of the audits reviewed were groups. On a number of those audits we considered the group audit teams' risk assessment, direction and supervision of component audits to be of a high standard.

##### *Co-ordination with and the resolution of matters raised by internal specialists*

Audit teams often use internal specialists to provide audit evidence in support of key assumptions. We saw examples of good practice where there was clear evidence of interactions between audit teams and auditors' experts including audit teams actioning points raised for follow up by the experts.

---

## Developments in the year

The firm's merger with Moore Stephens has resulted in an increase of approximately 20% in the number of entities within AQR's scope, with greater concentration in the insurance and shipping sectors. The firm should focus on maintaining audit quality as the Moore Stephens audits are integrated with those of the firm, following initial parallel running of the legacy systems. The firm should also ensure that the different ethical monitoring systems and quality control procedures are effectively embedded in the enlarged firm.

Following actions from the firm, we have seen an improvement in relation to most of the key findings we highlighted in last year's report.

During the year, the firm extended its systems for monitoring compliance with Ethical Standards, including in the following areas:

- Extending monitoring of financial interests to prioritise higher risk individuals.
- Extending compliance testing to all staff.
- Completing initial planning to implement a system to log personal financial interests.
- Implementing central monitoring of communications of ethical and independence breaches to audit committees.

The firm also made enhancements to its policies and procedures during the year in a number of other areas, including updating the process for appointing Engagement Quality Control Reviewers.

We note the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2018/19 inspection.

### **Audit Quality Review**

FRC Audit and Actuarial Regulation Division

July 2019

---

This report has been prepared for general information only. The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2019  
The Financial Reporting Council Limited is a company limited by guarantee.  
Registered in England number 2486368.  
Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

**FINANCIAL REPORTING COUNCIL  
8TH FLOOR  
125 LONDON WALL  
LONDON EC2Y 5AS**

**+44 (0)20 7492 2300**

**[www.frc.org.uk](http://www.frc.org.uk)**