



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2008/9 INSPECTION OF PRICEWATERHOUSECOOPERS LLP

5 NOVEMBER 2009

This report is issued by the Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council. It has been approved for publication by the Oversight Board.

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1 Scope, objectives and background information

1.1 Introduction

This report sets out the principal findings arising from the inspection of PricewaterhouseCoopers LLP (“PwC” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), part of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2009 (“the 2008/9 inspection”). Our inspection visit was primarily conducted in the period from April 2008 to March 2009 (referred to as “the time of our inspection”). This is the second year the AIU has reported publicly on individual firms.

This report is based on the AIU’s more detailed private report on its inspection of the firm to the Audit Registration Committee (“the ARC”) of the Institute of Chartered Accountants in England and Wales (“the ICAEW”), with whom the firm is registered for audit purposes. The AIU currently inspects the largest audit firms, including PwC, annually¹. The 2008/9 inspection was the AIU’s fifth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2008/9 report to the ARC, which was finalised in June 2009, recommended that the firm’s registration to conduct audit work should be continued.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU’s overall inspection programme for the relevant year.

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 by the AIU which, in turn, reflects the firm’s client base. An issue reported in relation to a particular firm might also apply to other firms without having arisen in the course of the AIU’s 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.

¹ The Companies Act 2006, as amended with effect from 6 April 2008 by the Statutory Auditors and Third Country Auditors Regulations 2007, requires that full scope inspections of those audit firms conducting more than ten audits within the scope of independent inspection (as determined by the Professional Oversight Board) are undertaken at least every three years.

All findings requiring action set out in this report have been discussed with the firm, together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU during its next inspection of the firm.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there is necessarily a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The firm was invited to provide a response to this report for publication. The firm's response is set out in Appendix A.

The AIU acknowledges the co-operation and assistance received from the partners and staff of PwC in the conduct of the 2008/9 inspection.

1.2 Scope and objectives

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing to this aim is for users of audit reports to be able to place a high degree of reliance on audit opinions, including whether financial statements show a true and fair view. The AIU's programme of inspections is designed to contribute to the achievement of this strategic outcome.

Our inspections of the major audit firms, on which we report publicly, 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 by the Oversight Board.

We review firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Independence and ethics
- Audit methodology

Our reviews of individual audits place emphasis on the appropriateness of significant audit judgments exercised in reaching the audit opinion, as well as the sufficiency and appropriateness of the audit evidence.

Our inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)² and other relevant requirements under the Audit Regulations³. 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.

We seek to identify areas in which improvements are, in our view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. We also assess the extent to which the firm has addressed the findings arising from its last AIU inspection.

While the AIU's 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. Our inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

We reviewed the quality of 14 individual audit engagements undertaken by the firm in our 2008/9 inspection. These related to FTSE 100, FTSE 250 and other major public interest entities with financial year ends between March 2007 and May 2008, the majority of which were December 2007 or later. Our reviews covered selected aspects of the audit only. In addition, we undertook two follow-up reviews to assess the extent to which our prior year findings had been addressed in the following year's audit.

The monitoring units of the professional accountancy bodies in the UK which register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within

² International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

³ The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, 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 (“a full listing”) and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

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, the Oversight Board, the AIU and their 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.

1.3 Background information on the firm

The firm is a UK limited liability partnership. It is a member of the PwC global network of firms, which have common policies and procedures in a number of areas, along with common audit systems and methodologies.

The firm is organised into three “lines of service”, being Assurance, Tax and Advisory. All statutory audit work is performed within the Assurance line of service, which is divided into industry and geographical “business units” for operational purposes, based in 37 offices within the UK.

For the year ended 30 June 2008, the firm’s turnover was £ 2,244 million, of which £1,043 million relates to the Assurance line of service (“Assurance”). The average number of employees was 15,189, including 6,763 relating to Assurance⁴. There were a total of 884 partners, of whom 262 were authorised to sign audit reports, along with 123 employees (audit directors) who were also authorised to sign audit reports⁵.

The AIU estimates that the firm had 520 audit clients within the scope of independent inspection by the AIU as at the 2008/9 reference date of 28 February 2008. Of these audit clients, AIU records show that 241 had a full listing or were listed on the AIM market of

⁴ As disclosed in the firm’s annual report for the year ended 30 June 2008. An analysis of Assurance turnover between audit and non-audit fees is not publicly available.

⁵ As disclosed in the annual return to the ICAEW as at 31 December 2008.

the London Stock Exchange⁶, including 38 FTSE 100 audit clients and 69 FTSE 250 audit clients.

1.4 Reporting on AIU reviews of individual audit engagements

The AIU introduced new reporting arrangements in respect of its reviews of individual audit engagements commencing from 2008, with the objective of increasing transparency and meeting the increased expectations of stakeholders. This involved issuing new letter style reports on audits reviewed by the AIU. Although addressed to the relevant audit engagement partner or director, the Oversight Board expects firms to provide copies of these reports to the directors of the relevant clients.

⁶ The firm also had other AIM listed audit clients below the threshold for inclusion within the AIU scope.

2 Findings

2.1 Overview

Our review of PwC's strategy, risk and quality plans and key audit related communications indicated the significance placed by the firm on audit quality.

In our view, the firm has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas which are subject to our review. Of particular note is the continual monitoring of audit quality related Key Performance Indicators, as described in section 2.2.6, and the communications and other actions relating to the audit implications of the economic downturn, as explained in section 2.2.3; these procedures are likely to make a positive contribution to audit quality. We identified certain areas for improvement in relation to the firm's policies and procedures, as set out in sections 2.2 to 2.4 of this report, including the linkage between audit quality and remuneration, as set out in section 2.2.2.

In relation to reviews of individual audits, we have generally reported our findings by reference to significant 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 audits.

We were generally satisfied, subject to our comments in section 2.4.3, with the basis on which significant audit judgments were made on the 14 audits reviewed by us. In our view, audit procedures were generally performed to a good or acceptable standard and, in relation to one listed entity, to a very good standard. The overall findings arising from our review of individual audits are set out in section 2.4; these include areas where improvements are, in our view, needed in order to enhance audit quality.

In our view, two of the audits we reviewed, both relating to listed entities, required significant improvements in relation to the audit evidence obtained or the recording of evidence on the audit files in certain areas of the audit.

The two follow-up reviews we conducted showed that the issues we raised in the previous year had been addressed on those audits.

PwC has generally made good progress in addressing our overall findings from last year. However, certain issues continue to recur. In this context, we note that the audits reviewed were undertaken before the firm's 2008 training programme, which primarily took place in the summer and focused on a number of the recurring issues. We would

expect this to result in improvements in future audits although, as explained in section 2.4.1, some of these issues may not be adequately addressed until the current audit system is replaced.

The principal findings arising from our review of the firm's policies and procedures supporting audit quality and the quality of the individual audits selected by us for review are set out below under three broad headings: quality control (section 2.2); independence and ethics (section 2.3); and audit performance (section 2.4).

2.2 Quality control

This section covers our review of the following aspects of the firm's system of quality control for audit engagements:

- 2.2.1 Leadership, strategy and communications
- 2.2.2 Performance evaluation, promotions and remuneration
- 2.2.3 Other human resource matters
- 2.2.4 Client risk assessment and acceptance/continuance
- 2.2.5 Consultation and review
- 2.2.6 Audit quality monitoring

2.2.1 Leadership, strategy and communications

The UK firm is headed by an Executive Board, which includes the Chairman, Managing Partner and heads of the three lines of service (Assurance, Advisory and Tax).

The strategy of the firm includes priorities relating to clients, people, knowledge, quality and risk and financial performance. The firm communicates matters relevant to audit quality on a regular basis; there are a variety of communication techniques, including training, web-casts, newsletters and meetings.

We met members of the Executive Board and other senior partners and reviewed the firm's strategy, risk and quality plans and key communications relating to audit quality, to assess the emphasis placed by the firm on audit quality.

We believe that the firm's strategy, communications and actions demonstrate the importance the firm attaches to achieving quality audits. However, there has been an increased emphasis on financial growth. Although there is no evidence to suggest that this has detracted from the focus on audit quality, in our view it is important for the firm to send a consistent message that achieving the other areas of the strategy is subject to the overriding requirement of achieving quality audits.

Transparency report

The largest audit firms agreed to publish transparency reports in response to the recommendations of the “post-Enron” group, set up by the Government. In September 2008 PwC published its second transparency report, in advance of a statutory requirement to do so, under regulations made by the Oversight Board.

The firm’s 2008 transparency report has been produced on a voluntary basis, but does not include a description of the quality control system and independence practices which would be required to be included once the statutory requirement comes into effect. In addition, it is less informative than the firm’s prior year’s report and those reports published by the other Big 4 firms during the year. We expect that the report will be expanded in 2009 to comply with the relevant regulations, which will then be in effect.

2.2.2 Performance evaluation, promotions and remuneration

Audit partners and staff (“audit personnel”) are appraised annually in relation to their overall performance and against agreed objectives; these are reviewed by counsellors who are assigned to individuals and who take into account evidence gathered, such as job appraisals and the individual’s overall self-appraisal for the year, before proposing a performance rating. Moderation processes take place before these ratings are approved.

There are separate processes for the key stages of promotion to audit director and partner, which include an independent review of the evidence to support promotion.

Partner remuneration is determined according to a model, primarily based on role levels and performance ratings. Remuneration for staff has a different model, mainly based on seniority and performance ratings. Staff are eligible for bonuses, which are calculated on a number of factors, including their own performance and the financial performance of the firm.

We reviewed the performance evaluation and promotion procedures, relevant guidance and communications, a sample of partner and staff appraisals and promotion nomination files and the remuneration models.

We concluded that the performance evaluation procedures are generally designed to ensure that performance ratings are based on consideration of the firm’s key priorities, including audit quality, that the performance ratings are a key element in the remuneration of audit personnel and that the firm puts significant resource into its performance evaluation procedures.

We note below areas for improvement in relation to the linkage between audit quality and remuneration and the assessment of competencies necessary for auditors. We also comment on changes to the staff bonus scheme below, the setting of objectives for reducing hours on audits in section 2.2.3 and on the rewarding or setting of objectives for the selling of non audit services to audit clients in section 2.3.1.

Changes to staff bonus scheme

One element of the staff bonus scheme relates to the relevant business unit's performance against certain Key Performance Indicators (KPIs). We note that the basis of this has changed for 2009 to give a 40% weighting to financial growth as part of the KPI element, double the 20% weighting given to the other KPIs, including audit quality. This represents a change from an equal weighting of 25% for each KPI last year and emphasises the importance of financial growth to the firm. We consider that the underlying message that this change gives represents a potential risk to audit quality in the future, although we were informed by the firm that the change was small in terms of total remuneration and was not intended to undermine the importance of audit quality.

Linkage between audit quality and remuneration

We believe that the firm should improve the clarity of the linkage between quality related inputs, such as feedback during the moderation processes, and the performance ratings of individuals, so that it is able to demonstrate more clearly the extent to which remuneration is based on considerations of audit quality. Other than in relation to a small number of partners with recurring quality issues, there does not appear to have been any improvement since we raised the matter with the firm last year. We believe the firm should give a higher priority to addressing this matter.

Assessment of competencies necessary for auditors

The firm's procedures for assessing competencies of audit personnel include on the job coaching and appraisals, year end performance evaluations and the moderation processes. The firm has a competency framework, which details those competencies expected for different levels of seniority. Last year we noted that this had not been embedded in the performance evaluation processes.

During 2008, communications were made to encourage audit personnel to consider the competency framework in the annual appraisal process. The competency framework was embedded into the performance evaluation system for staff up to senior manager level, but not for directors and partners. We were informed that the system will be updated for

directors in 2009 and that there will be improvements in the procedures to assess the technical competencies for partners.

2.2.3 *Other human resource matters*

Objectives for reducing hours on audits

There have been a number of initiatives during the year to improve profit margins, primarily through efficiencies on audits, such as eliminating duplicated work and maximising reliance on clients' controls. The way audit personnel have been encouraged to improve margins on audits has varied between business units. In the case of one business unit, audit personnel were given an overall objective to reduce audit hours by five percent, through efficiencies.

The achievement of these type of objectives can affect performance ratings, and therefore remuneration. In our view, while it is appropriate to identify means of improving efficiencies on audits, any objective of this nature should make it clear that it must not affect audit quality. This is especially the case for standard objectives applied across a business unit and affecting a range of audit personnel. We also believe that any objectives related to audit hours should take into account the need for increased effort in those areas of the audit affected by the economic downturn, to be consistent with the firm's communications on responding to the economic downturn (as described below).

Audit training and communications

Audit training for junior staff, prior to qualification, is incorporated into the mandatory annual core training courses. Senior staff and partners in Assurance are required to attend an annual update course, covering audit and accounting updates, changes to audit methodology and areas identified as requiring improvement; this year the course included a test for the first time. We have been informed that there was full attendance of this course in 2008.

We met personnel from the training and technical departments and reviewed certain audit training material and technical updates. We concluded that the mandatory audit training for audit personnel is comprehensive and includes consideration of new requirements and identified development needs.

Nearly all mandatory audit class-room training for senior staff and partners is held in the summer. While regular updates, including webcasts, are made during the rest of the year, to cover matters such as quality review findings, these are not as comprehensive as the class-room training and are not all mandatory. In our view, the firm should provide

more detail regarding external quality review findings in its webcasts and should make all such webcasts mandatory.

Communications and other actions relating to the economic downturn

The firm has provided a significant amount of guidance to audit personnel in relation to the audit implications of the economic downturn and current market conditions, including technical communications, web-casts and training. In addition to the Assurance wide actions and communications, there have been initiatives at a business unit level, such as practice aids on specific subjects, especially for financial services audits.

The risk assessment procedures have been enhanced at a business unit level, where the portfolio reviews of audits by risk management partners have included discussions with audit partners on going concern, valuation and impairment issues. The firm has also enhanced its existing consultation procedures to respond to the increased level of risk. There has been an enhanced central technical panel process to consider specific going concern and other relevant issues, supplemented by additional technical panels at certain business units. There have also been other business unit initiatives on going concern, for example workshops held on the subject. These actions and communications were detailed and were provided on a timely basis.

2.2.4 Client risk assessment and acceptance/ continuance

Firms are required to have policies and procedures in place to provide them with assurance that client integrity, compliance with ethical requirements and their competence, capabilities and resources are considered before they decide whether to accept or continue an audit engagement⁷.

There is a central risk management function in Assurance and each business unit has a risk management partner, responsible for risk management procedures for the audits in that business unit.

In addition to specific procedures for acceptance of new audits, all audit teams are required by the firm to complete an acceptance and continuance (A&C) form annually for their audit clients. This generates a risk score, based on a number of standard questions. If this risk score exceeds a certain level, the A&C decision is required to be approved by a risk management partner. While the A&C process does not necessarily

⁷ International Standard on Quality Control (UK and Ireland) 1, paragraph 28.

identify all of the firm's highest risk clients, partly due to timing, there are other risk assessment procedures at a business unit level which cover high risk clients.

We reviewed the firm's A&C policies and procedures and selected a sample of annual continuance forms for review. We concluded that the A&C policies and procedures are generally comprehensive and were complied with on the audits reviewed by us.

2.2.5 *Consultation and review*

Engagement quality control review

Firms are required to have policies and procedures in place requiring an engagement quality control review to be undertaken for all audits of financial statements of listed entities and other audits meeting specified criteria⁸. The firm refers to such reviews as Quality Review Partner (QRP) reviews and this terminology is used in this report.

QRP reviews are performed by independent experienced partners. They are required for all listed audits and certain other higher risk audits. Specific training is provided to new QRPs. We reviewed the application of the QRP review procedures as part of our review of individual audits and met a selection of the relevant QRPs. We found that the QRPs on those audits were involved on a timely basis and in line with the firm's required procedures.

Pre-issuance technical reviews

The firm requires all financial statements of listed entities to be subject to a technical review within the firm, prior to signing the relevant audit report. For FTSE 350 audits, the review is undertaken by a group of experienced senior managers including personnel from the accounting technical department. For other listed entities, the review is performed by someone at senior manager level, accredited by their business unit.

The reviews are required to be overseen by a partner in the accounting technical department, in the case of FTSE 100 audits, and by the QRP for other listed audits. All reviewers are required to attend annual training relating to their role as technical reviewer.

We met partners from the accounting technical department, reviewed the relevant training material and reviewed the output of the technical reviews as part of our reviews

⁸ International Standard on Quality Control (UK and Ireland) 1, paragraph 60.

of individual audits. We found that the technical reviews on the audits reviewed by us were of a good standard, especially for the FTSE 100 audits.

2.2.6 *Audit quality monitoring*

Firms are required to have monitoring procedures in place, including reviews of a selection of completed audit engagements, to provide them with assurance that their system of quality control is adequate, operating effectively and complied with in practice. Such monitoring is required to be undertaken at least annually⁹.

The firm's processes to monitor audit quality comprise the following:

- A review of audit quality Key Performance Indicators (KPIs), covering specific areas of the audit, on a continuous basis. This process involves the review of selected audits on a quarterly basis by the business units to ensure the firm's policies and procedures are being complied with in the specific areas covered by those KPIs.
- An Assurance Quality Review (AQR), being an annual review of a sample of audits by personnel independent of the business units where the audits are located; this is planned in line with the firm's global requirements. A grading system is used, whereby the audits are graded either "satisfactory", "needs improvement" or "unsatisfactory". The AQR is designed to cover all personnel authorised to sign audit reports every three years, all audit directors in their first year of authorisation to sign audit reports and any personnel authorised to sign audit reports with an AQR grading other than satisfactory in the prior year. A total of 180 audits were reviewed between January and September 2008.
- An annual Audit Compliance Review (ACR), which monitors the firm's compliance with the ICAEW's Audit Regulations, and includes a review of the procedures performed by certain central functions, such as the compliance department. This process involves an independent team, separate from the central functions, performing the review.

We reviewed these processes, the 2008 results, and the follow up actions by the firm. The firm invests significant effort and resource in these processes and responding to the findings. We believe the KPI and ACR processes to be particular strengths within the quality monitoring procedures.

⁹ International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations.

The AQR selection criteria exceed the minimum regulatory requirements, which demonstrates the importance placed by the firm on the AQR process. There is evidence that the AQR process can be effective in identifying matters which require improvement, although, as noted below, there was some inconsistency between the AQR and AIU findings.

Consistency of AQR and AIU findings

For the two listed audit engagements which were reviewed both as part of the firm's AQR and by the AIU, while the AQR concluded that these audits were satisfactory, we identified a number of areas requiring improvement, with significant improvements required in certain areas on one of those audits.

While we would not expect the results of the AQR and AIU reviews to be the same, due to the different scoping and depth of the reviews, the firm should identify and address the underlying causes of the differences identified between the AIU and AQR findings.

Personnel with recurring quality issues

There were six audit engagement partners and two audit directors who had a "needs improvement" AQR finding on one of their audits in the year and at least the same finding in the prior year. Three of these partners had business unit management positions in the firm, with competing responsibilities. In our view, the firm should identify the extent of the linkage between the client work load and competing responsibilities of those partners and the results of the AQR.

2.3 Independence and ethics

2.3.1 Ethical policies and consultation

Firms are required to have policies and procedures in place designed to achieve compliance with the Ethical Standards issued by the APB, together with relevant ethical pronouncements issued by the professional body with which the firm is registered.

The firm's independence policies are based on the global network's independence policies, amended to reflect additional requirements of the Ethical Standards in the UK. The firm had already, in prior years, mapped the requirements of the Ethical Standards to its policies and procedures. During 2008 the policies and procedures were amended to reflect certain revisions to the Ethical Standards.

The Compliance department, headed by the Ethics Partner, is responsible for independence training and consultation. Mandatory computer based independence training is undertaken annually by all audit personnel.

We reviewed the firm's ethical policies and found them to be generally comprehensive. We comment below on those areas where, in our view, the policies or guidance should be reviewed by the firm.

Objectives for selling of non-audit services to audit clients

The APB Ethical Standards state that the audit firm should establish policies and procedures to ensure that, in relation to each audit client, no specific element of the remuneration of a member of the audit team is based on his or her success in selling non-audit services to the audit client¹⁰. This requirement is in place in order to reduce the self-interest threat to independence.

As noted last year, the firm's policies and guidance explicitly permit internal specialists (such as tax partners) involved in audits, including "key partners involved in the audit" (KPs)¹¹, to be rewarded for selling non-audit services to those audit clients, on the basis that they are not considered by the firm to be part of the "audit team". In our view, the underlying principles of the Ethical Standards would indicate that they should be treated in the same way as other audit partners who are responsible for key audit decisions and the firm should amend its policy accordingly.

While the firm's communications state that the firm will not reward audit team members for selling non audit services to their audit clients, one of the firm's communications reviewed by us also stated that demonstrable effort in following up client contacts in order to identify opportunities to "add value" to clients would be rewarded. In our view, these type of communications should make it clear that, while effort in enhancing client relationships may be rewarded, it is not appropriate to reward audit team members on the basis of whether the identification of specific opportunities results in sales of non audit services to those audit clients.

Our reviews of appraisals and objectives also identified examples where audit team members appeared to seek recognition in relation to securing non audit services to their own audit clients. It is not possible for us to ascertain whether or not this would have affected the performance evaluation, and therefore the remuneration, of those concerned. However, in all cases the self-appraisals or objectives were agreed by the counsellors. The

¹⁰ APB Ethical Standard 4 (Revised), paragraph 38.

¹¹ "Key partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

firm informed us that a review of partner appraisals was subsequently undertaken and that this identified no evidence that audit partners had received any reward based on their success in selling non audit services to their audit clients.

We were subsequently informed by the firm that it was taking a number of actions in this area to address the underlying findings, including communications and guidance to relevant partners. The actions included a requirement for audit partners to review their objectives for 2009 and to certify that this had been done. These actions demonstrate that the firm has taken our findings in this area seriously.

2.3.2 Compliance monitoring procedures

The firm performs an annual independence confirmation exercise, which requires partners and staff to answer a series of questions on their personal independence, including financial interests. The annual exercise started in May 2008 and was completed by January 2009. The firm also performs testing of the financial interests of partners and senior staff.

These exercises, in 2008, identified a small number of partners as having inadvertently breached Ethical Standard requirements. Partners breaching external regulatory and internal requirements are considered for disciplinary action by the Executive Board of the firm.

We met the Ethics Partner, reviewed a sample of annual independence declaration forms and reviewed the results of the independence confirmation exercises. We concluded that the firm's annual independence confirmation process is comprehensive and that much resource is spent on the follow up of potential issues.

2.3.3 Rotation policies and monitoring

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the engagement partner and QRP are required to rotate after having served for a maximum period of five years and key partners (KPs) are required to rotate after seven years¹².

¹² APB Ethical Standard 3 (Revised), paragraphs 5,6,12 and 18.

The firm revised its rotation policies and guidance in the year to reflect the revisions to the Ethical Standards.

Audit partners are responsible for ensuring compliance with rotation requirements on their audit clients. The firm also maintains a rotation database which includes information on the rotation period for senior members of the audit team. The entries on the database are monitored on an ongoing basis by the business units. This year the database was updated to include overseas KPs, in line with the updated requirements of the Ethical Standards. As at the end of 2008, the rotation database included KPs on nearly all of the firm's FTSE 100 audits.

We met the business unit leaders to discuss the rotation monitoring procedures performed in the year and reviewed the firm's rotation database. In addition, we reviewed compliance with rotation requirements as part of our review of individual audits. In our view, the firm has comprehensive rotation policies and procedures, although we believe that the policies for former engagement partners moving to a client relationship role should be reviewed, as detailed below.

Engagement partners moving to a client relationship role

The firm's rotation policies allow an audit engagement partner to take on the role of client relationship partner after a cooling off period of two years. While the Ethical Standards are not clear on this matter, our interpretation is that there would be a five year cooling off period in this situation, which is in line with our understanding of general market practice¹³. The firm has informed us that it will consider this matter further in view of our comments.

2.3.4 Non audit services

Partners and directors are required to confirm each year whether they have complied with the firm's policies in relation to performing non-audit services for audit clients. In addition, any non-audit service provided to a listed audit client is required to be authorised by the group audit partner.

This year, the firm introduced quarterly reviews of these authorisations. We were informed that this identified a number of issues relating to the adequacy of the documentation of the threats and safeguards in relation to the non-audit services and the timeliness of the authorisations.

¹³ APB Ethical Standard 3 (Revised), paragraphs 12 and 14.

Training has been provided to partners and staff in this area. In addition, templates for documenting threats and safeguards were under development at the time of our inspection and were planned to be issued in the first half of 2009. We will follow up the progress in this area as part of next year's inspection.

2.4 Audit performance

This section covers findings arising from our review of the firm's audit methodology and our review of individual audits. Our findings are set out under the following headings:

- 2.4.1 Audit methodology
- 2.4.2 Assessing and responding to risk
- 2.4.3 Audit evidence and related judgments
- 2.4.4 Communicating with Audit Committees
- 2.4.5 Audit finalisation

Any findings relating to quality control and independence are covered in sections 2.2 and 2.3 respectively.

2.4.1 Audit methodology

PwC's audit methodology and guidance are developed on a global basis, and are supplemented by guidance on UK specific requirements. Supporting audit tools and guidance have been developed both globally and specifically for the UK. The audit systems are electronically based. The audit work programmes use a library of standard procedures, developed centrally, which can be tailored by audit teams.

In prior years we have reviewed the firm's mapping of the requirements of Auditing Standards to its audit methodology. This year we reviewed any updated material, for example due to any changes in requirements, as well as the audit technical alerts issued in the year. We reviewed the application of the firm's audit methodology on the audits selected for our review.

We believe that the firm's audit methodology and systems are generally sufficient to enable audit teams to comply with Auditing Standards, but the audit system does not easily facilitate compliance with the relevant requirements relating to risk assessment and the linkage between the planned and actual audit approach.

Based on our review of the firm's methodology and its application on individual audits we comment below, and in sections 2.4.2 to 2.4.5, on those areas where improvement is, in our view, required.

Audit systems and risk assessment methodology

We have been informed that the firm's risk assessment methodology and related procedures will not be updated until the current audit system is replaced, which is planned in the foreseeable future. The firm has also informed us that it believes that the findings both this year and last year relating to the differences between the planned and actual audit approach, as set out in section 2.4.3, are in part due to the current audit system. In our view, these should remain areas of focus of the firm prior to replacing its audit systems.

Methodology and guidance for financial services audits

In our view, aspects of the firm's audit methodology are not easy to apply to certain financial services entities. The audit methodology and formal audit guidance is designed to cover all types of audits and does not include tailored guidance or a library of standard audit procedures for financial services audits. While certain informal guidance exists for financial services audits, we understand that some of it is considered by the firm to be out of date. In our view, certain areas of the firm's audit methodology and guidance need to be tailored for financial services audits.

Using the work of internal audit

Last year we noted that the firm's guidance did not adequately cover the circumstances where using the work of internal audit for substantive testing purposes, or obtaining direct assistance from internal audit staff on the external audit, may be appropriate. However, the guidance had not been expanded by the firm in these areas at the time of our inspection.

Representation letters

We identified certain omissions from the firm's standard representation letter in the pro-forma letter used for pension funds and unit trusts. Both of these standard letters have been subsequently amended.

2.4.2 Assessing and responding to risk

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including which of those risks require special audit consideration (such risks are termed "significant risks")¹⁴. A proper assessment of

¹⁴ International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108.

the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

Overall risk assessment

The firm has a standard template which records details of significant risks and the work planned and performed to address those risks. This was generally completed to a good standard, with an improvement in the standard of completion compared with the audits reviewed by us last year. There is no standard format for recording non significant risks or linking them to the audit procedures performed, and we identified issues with the recording of these risks in practice.

Other than the recording of significant and other risks, the firm has no requirement to explicitly document the assessed risk of material misstatement for specific areas of the financial statements, on the basis that there is an implicit assessment in the procedures planned and performed. In our view, this assessment is not always adequately demonstrated in practice.

Fraud risk assessment – revenue recognition

Auditing Standards state that the auditor usually presumes that there is a risk of fraud in revenue recognition¹⁵, as it is an area which can be more prone to material misstatement arising from fraudulent financial reporting.

The majority of audits we reviewed did not identify revenue recognition as a significant fraud risk. This is inconsistent with the firm's audit guidance, which states that only in limited circumstances should revenue recognition not be treated as a significant risk. In addition, in a minority of audits reviewed, the rationale for not identifying revenue recognition as a significant fraud risk was either not set out on the audit files or inappropriately took into account the effectiveness of controls.

Fraud risk response – testing of journals

Auditing Standards require journals to be tested in response to the risk of management override of controls¹⁶. The approach to journal testing varied significantly amongst the audits reviewed; we identified issues regarding the approach taken on a minority of those audits. For example, on one audit, while manual journals posted outside normal hours were tested, along with consolidation and one-off journals, those recurring journals raised during normal hours had not been selected for testing.

¹⁵ International Standard on Auditing (UK and Ireland) 240, paragraph 60.

¹⁶ International Standard on Auditing (UK and Ireland) 240, paragraph 76.

We identified few examples where Computer Assisted Audit Techniques had been used to identify journals to be selected for testing. In our view, these techniques should be more widely considered, especially in entities with a significant number of journals. In our view, there should be more consideration given to the sampling method and criteria used to select journals for testing and the need to test journals throughout the period in order to ensure that the testing of journals is sufficiently responsive to the risk of fraud.

2.4.3 Audit evidence and related judgments

Audit judgments

The firm requires audit teams to record matters of significant judgment in a separate section in the audit files, and these are required to be reviewed by the audit engagement partner and the QRP. This helps to ensure that appropriate focus is given to setting out the rationale for the key areas of judgment and, on the audits we reviewed, these sections were generally adequately completed.

We reviewed a number of significant audit judgments, including the rationale for accounting treatments, the reasonableness of assumptions in valuations and estimates and the judgments relating to the extent of audit work performed. We were generally satisfied with the justification of the significant audit judgments, although we identified issues relating to the extent of audit work performed in certain areas, as noted in this section of the report.

Audits requiring significant improvement in certain areas

On one listed audit, in our view, there was insufficient substantive audit evidence obtained for revenue and certain related balances, direct expenses and trade and other payables, all material areas of the financial statements. The approach was to obtain nearly all of the audit evidence in these areas from the testing of controls. Analytical procedures had not been performed in these areas as a way of obtaining substantive audit evidence and, in our view, insufficient substantive testing was performed.

On another listed audit, in our view, there was insufficient substantive audit evidence on the audit files for revenue and trade and other payables, both material areas of the financial statements. We identified a number of examples on this audit where the audit files did not adequately set out the audit evidence obtained for these areas of the financial statements, and we had to seek oral explanations by the audit team to

determine the work performed and evidence obtained. Auditing Standards state that oral explanations on their own do not represent adequate support for work performed¹⁷.

Differences between planned and actual audit approach

The firm has a standard template to summarise the planned audit approach, which is required to be updated for changes to plan and which also provides a summary of the audit evidence obtained. On the majority of the audits reviewed the audit approach, for one or more material areas of the financial statements, was not fully executed in accordance with the planned approach and it was difficult to determine the actual audit approach based on the audit files alone.

In our view, greater care should be taken to ensure that the audit approach is clearly set out on the audit files and that changes from the planned approach are adequately explained.

Approach to obtaining substantive audit evidence

Auditing Standards require substantive procedures to be performed for material classes of transactions and balances in the financial statements, regardless of the risk of material misstatement¹⁸. This reflects the fact that the auditor's risk assessment is judgmental and may not identify all risks, and that there are inherent limitations to internal controls, such as management override.

The firm's audit methodology and guidance states that where audit teams are able to obtain significant audit comfort through testing controls, most of the substantive evidence will often be obtained from substantive analytical procedures. However, we have seen a reduction in the use of analytical procedures as a means of obtaining audit evidence in the audits reviewed by us, even where there was a high degree of reliance on controls. This has partly been due to audit teams having been encouraged, as part of the firm's training, to consider whether the use of substantive analytical review procedures is always appropriate, because of the previous issues identified in applying the firm's methodology. This has resulted in a need to obtain more substantive audit evidence through tests of detail and, in the audits reviewed by us, it was not always easy to ascertain what audit evidence had been obtained from tests of detail.

The firm's methodology and guidance allow a high degree of judgment in deciding the audit approach to be adopted when performing tests of detail to obtain substantive audit

¹⁷ International Standard on Auditing (UK and Ireland) 230, paragraph 11.

¹⁸ International Standard on Auditing (UK and Ireland) 330, paragraph 49.

evidence. In our view, the firm needs to provide more guidance on the appropriate testing strategy to obtain substantive audit evidence.

Stock count procedures

In the large majority of the audits reviewed by us where there were material stock balances, the client performed perpetual counts on a daily basis across one or more locations. While the auditors reviewed the results of the counts throughout the year, observation and testing of the counts was only performed on one day at a sample of the locations. In our view, the counts should also have been attended at other times in the year.

On one of these audits, where the client had a significant number of locations across the UK, although the auditors attended a sample of the locations, observation and testing of the stock counts was only performed by them at one of the locations and the results thereof were not included on the audit files.

In our view, there is a need for the firm to ensure that audit teams gain a better understanding of the audit procedures required when relying on perpetual count procedures.

2.4.4 Communicating with Audit Committees

Auditing Standards require the auditor to communicate matters of governance interest arising from the audit with those charged with governance of the entity. Such communications will usually take place with an Audit Committee, or similar body acting on behalf of the Board¹⁹. Appropriate communication with the Audit Committee or other relevant governance body contributes to the quality of the audit and assists both parties to discharge their responsibilities effectively.

In our view, the reporting to Audit Committees was generally of a good standard and communications were made on a timely basis.

2.4.5 Audit finalisation

Audit finalisation procedures include a final analytical review of the financial statements as a whole, a review of events occurring after the end of the financial year that may require adjustment of, or disclosure in, the financial statements (“subsequent events”)

¹⁹ International Standard on Auditing (UK and Ireland) 260, paragraph 11.

and consideration of the appropriateness of the going concern assumption in preparing the financial statements.

In our view, except for the assessment of going concern, audit finalisation procedures were generally performed to a good standard.

Going concern assessment

Auditing Standards require the auditor to evaluate the Board's assessment of the entity's ability to continue as a going concern, having made enquiries of the Board and examined appropriate available financial information²⁰.

In a small minority of the audits reviewed by us, we were informed that there had been no formal assessment of going concern by the Board in support of the statement confirming the appropriateness of adopting the going concern basis made in the Annual Report. In addition, on a minority of the other audits reviewed by us, there was no evidence of such an assessment by way of Board papers or minutes. In these cases, the audit teams had performed their own procedures on going concern. In our view, however, they should have requested the Board to evidence its assessment of going concern.

The audits reviewed by us were finalised before the full extent of the economic downturn became apparent. We were pleased to note that the firm issued a significant amount of additional guidance in relation to the assessment of going concern towards the end of 2008. We will review this area further in 2009/10.

5 November 2009

END OF REPORT

²⁰ International Standard on Auditing (UK and Ireland) 570, paragraph 17-1.

Appendix A – Firm’s response

The firm’s response is on the following page.

Audit Inspection Unit
Aldwych House
71-91 Aldwych
London
WC2B 4HN

Attention: Mr Andrew Jones

27 October 2009

Dear Sir,

AIU public report on the 2008/9 inspection of PricewaterhouseCoopers LLP ('PwC')

We appreciate the opportunity to respond to the AIU's report and findings in respect of its 2008/9 visit to PricewaterhouseCoopers LLP ('PwC').

We remain committed to working constructively with the AIU and we take seriously the findings identified during your visit. We believe we benefit from the insight that your comments offer and are able to utilise this to make what we do more robust, and are pleased that our actions to address these findings are also reflected in your report.

Our Firm is built around our independence and integrity and we recognise the public interest vested in our audit practice. We also recognise our responsibility for the confidence that the audit delivers to investors and society. We believe that independent regulation and oversight are central to the maintenance of confidence in audits and are therefore very pleased with your positive comments on our uncompromising approach to audit quality and appreciate your comments that our policies and procedures are appropriate and that you were generally satisfied with the basis on which our significant audit judgments are made.

It is our fundamental belief that our ability to deliver the highest audit quality is influenced by our ability to continue to recruit the best and brightest and provide meaningful, challenging and rewarding professional careers. This in turn will be influenced by our continued commercial success and so we regard our strategy to seek to grow our business as entirely consistent with our quality agenda. We are conscious of the need to balance our goal of achieving growth, in order to enable us to invest in quality and people, with the importance of continuing to deliver quality.

Yours faithfully



PricewaterhouseCoopers LLP



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