



## **AUDIT INSPECTION UNIT**

# **PUBLIC REPORT ON THE 2007/8 INSPECTION OF PRICEWATERHOUSECOOPERS LLP**

**8TH DECEMBER 2008**

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.

## Contents

	<i>Page</i>	
<b>1</b>	<b>Scope, objectives and background information</b>	<b>2</b>
<hr/>		
<b>2</b>	<b>Findings</b>	<b>7</b>
<hr/>		
	<b>Appendix A - Firm's response</b>	<b>22</b>
<hr/>		

# 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 2008 (“the 2007/8 inspection”). Our inspection visit was conducted in the period from April 2007 to February 2008 (referred to as “the time of our inspection”).

It 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, annually<sup>1</sup>. The 2007/8 inspection was the AIU’s fourth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2007/8 report to the ARC, which was finalised in June 2008, recommended that the firm’s registration to conduct audit work should be continued.

This is the first year the AIU has reported publicly on individual firms. In the past the AIU issued an annual public report in which the principal findings arising from its inspections of the major audit firms in the UK were dealt with on an anonymous and aggregated basis.

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

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<sup>1</sup> 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.

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.

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 Oversight Board undertook to publish all the reports for the 2007/8 cycle of inspections on a single date. 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 2007/8 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 obtained.

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)<sup>2</sup> and other relevant requirements under the ICAEW's Audit Regulations<sup>3</sup>. 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. (The APB issued revised Ethical Standards in April 2008 which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

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 and recommendations 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 sixteen individual audit engagements undertaken by the firm. These related to FTSE 100, FTSE 250, other listed and other major public interest entities with financial year ends between September 2006 and April 2007. Our reviews

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

<sup>3</sup> 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.

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 who 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 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.

The firm is also registered with the US Public Company Accounting Oversight Board ("the PCAOB") in relation to audits of entities with a listing in the United States or significant subsidiaries thereof. By agreement with the firm, staff from the PCAOB participated in certain aspects of this inspection.

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 39 offices within the UK.

For the year ended 30 June 2007, the firm's turnover was £ 2,107 million, of which £947 million relates to the Assurance line of service ("Assurance"). The average number of employees was 14,785, including 6,528 relating to Assurance<sup>4</sup>. There was a total of 850 partners, of whom 263 were authorised to sign audit reports, along with 109 employees (audit directors) who were also authorised to sign audit reports<sup>5</sup>.

The AIU estimates that the firm had 543 audit clients within the scope of independent inspection by the AIU as at the 2007/8 reference date of 27 February 2007. Of these audit clients AIU records show that 252 had a full listing or were listed on the AIM market of the London Stock Exchange<sup>6</sup>, including 39 FTSE 100 audit clients and 74 FTSE 250 audit clients.

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<sup>4</sup> As disclosed in the firm's annual report for the year ended 30 June 2007. An analysis of Assurance turnover between audit and non-audit fees is not publicly available.

<sup>5</sup> As disclosed in the annual return to the ICAEW as at 31 December 2007.

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

## 2 Findings

### 2.1 Overview

PwC has demonstrated the importance it attaches to audit quality through its strategy, commitment to continual improvement and its related communications.

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, which ensures that audit quality is high on the agenda for audit personnel. We identified certain areas for improvement in relation to the firm's policies and procedures, for example the procedures relating to the assessment of the competencies necessary for auditors, as set out in sections 2.2 to 2.4 of this report.

In relation to reviews of individual audits, we have generally reported our findings on the basis of themes arising or issues of a similar nature identified across a number of audits. We believe that the number of individual audits reviewed by us makes it appropriate to report on this basis.

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 sixteen audits reviewed by us. In our view, audit work was generally performed to a good or acceptable 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.

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 made significant effort in implementing the recommendations we made last year, and addressing other needed improvements identified internally, especially in the area of rotation monitoring. However, certain issues continue to recur; the audits reviewed were undertaken before the firm's 2007 training programme, which focused on a number of the recurring issues. Whilst we would expect this to result in improvements in future audits, in our view a number of these areas should remain areas of focus in the firm's training and communications.

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 a Management Board, which includes the Chairman, two managing partners 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 with members of the Management 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 high quality audits.

### ***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.

Remuneration is determined according to a different model for partners and staff.

We reviewed the performance evaluation and promotion procedures, 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, and that the remuneration models include a significant element relating to performance. The firm puts significant resource into its performance evaluation procedures. However, we note the following areas for improvement.

#### *Linkage between audit quality and remuneration*

We believe that the firm should improve its evidence of how audit quality measurements, including the results of audit quality reviews, are linked to the performance ratings and remuneration of individuals, so that it is able to demonstrate more clearly the extent to which remuneration is based on considerations of audit quality.

#### *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. However, this had not been embedded in the performance evaluation process at the time of our inspection, although the firm was planning to do so soon afterwards. We believe this is important, as a competency framework assists in the assessment of whether audit personnel have the right level of competencies and whether there are any development needs for those individuals.

### **2.2.3 Other human resource matters**

#### *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. We have been informed that there was 100% attendance of this course in 2007, after additional sessions were held.

There are also other training programmes for audit personnel, including industry and skills related training, along with frequent communications relating to accounting and audit technical matters.

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

#### *Credit crunch communications*

The firm has provided a significant amount of guidance to audit personnel in relation to the audit implications of the “credit crunch”, including technical communications, webcasts and training. This was provided on a timely basis and included guidance for specific areas of financial services audits.

#### *Verification of qualifications for joiners*

The firm’s own compliance review had previously noted that there was no verification of the accuracy of qualifications on application forms for either graduates or experienced personnel. A full check was performed on the application forms for the 2007 intake of graduates, which resulted in about 1% of offers being withdrawn, due to misstated qualifications or omissions on application forms. There was no such verification exercise made for experienced personnel in 2007; we were informed that ongoing checks had started in 2008.

#### **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 engagement<sup>7</sup>.

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 score exceeds a certain level, the A&C form is required to be approved by a risk management partner.

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 that the approval procedures were notably thorough in one of the business units.

#### **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 criteria.<sup>8</sup> 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 involvement of the QRPs was generally well evidenced on those audits.

##### *Pre-issuance technical reviews*

The firm requires all audited financial statements of listed entities to be subject to an independent technical review within the firm. For FTSE 350 audits the review is undertaken by a dedicated group of experienced senior managers including personnel

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<sup>7</sup> International Standard on Quality Control (UK and Ireland) 1, paragraph 28

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

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 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 technical department, reviewed the relevant training material and reviewed the output of the technical reviews as part of our reviews 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. However, we were informed that the firm's technical department did not oversee the pre-issuance review of two FTSE 100 audits, in relation to audit opinions issued in 2007, which was not in line with policy. The financial statements did, however, receive a technical review by someone independent from the audit team and the reviews were overseen by the QRP. In our view, it is important that pre-issuance reviews are performed in accordance with policy, to ensure that an appropriately high standard of technical reviews of financial statements are performed.

### **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 annually.<sup>9</sup>

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 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

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

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 151 audits were reviewed between May and September 2007.

- 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 2007 results, and the follow up actions by the firm. The firm invests significant effort and resource in these processes, which we believe are effective in identifying matters which require improvement. We believe the KPI process to be a particular strength within the quality monitoring procedures.

Whilst the firm's procedures include follow up actions for those audit directors or partners whose audits had an AQR grading other than satisfactory, in our view, the follow up procedures and actions need strengthening in situations where individuals have had recurring quality issues.

## **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 Auditing Practices Board 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 2007 additional guidance was provided in certain areas, which included areas recommended by us last year.

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. However, in our view, the policies noted below should be reviewed by the firm, in light of the underlying principles of the ethical standards.

#### *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 client<sup>10</sup>. This requirement is in place in order to reduce the self-interest threat to independence.

The firm's policies and guidance explicitly permit internal specialists (such as tax partners) involved in audits, including "key audit partners" (KAPs)<sup>11</sup>, 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". Whilst the Ethical Standards exclude "professional personnel from other disciplines involved in the audit" from being part of the audit team for this purpose, they do not specifically state whether this extends to KAPs. 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.

#### *Direct assistance by client's internal audit staff*

On one audit reviewed by us, the audit team used certain internal audit staff to perform limited external audit procedures, directly for the audit team. Direct assistance by internal audit staff is not specifically covered in auditing or ethical standards, and the firm's policies allow this practice. In our view, the practice of including staff from clients' internal audit departments in external audit teams may be inconsistent with the underlying principles of the Ethical Standards, because it is not possible for such staff to be independent of their employers. We believe the firm should review the appropriateness of this practice and what safeguards should be applied to deal with such threats to independence.

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<sup>10</sup> APB Ethical Standard 4, paragraph 36

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

### **2.3.2 Compliance monitoring procedures**

The firm performs an annual independence confirmation exercise, which requires all partners and staff to answer a series of questions on their personal independence, including financial interests. The annual exercise started in May 2007 and was completed by the end of 2007. The firm also performs testing of the financial interests of partners and senior staff.

These exercises, in 2007, identified a small number of partners as having inadvertently breached ethical standard requirements. All partners breaching external regulatory requirements are considered for disciplinary action by the Management Board of the firm.

We met with the Ethics Partner and members of the compliance department, reviewed a sample of annual independence declaration forms and reviewed the results of the exercise. 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 audit partners (KAPs) are required to rotate after seven years<sup>12</sup>.

#### *Rotation policies and procedures*

Following our recommendations last year, the firm revised its guidance on partner rotation in late 2007. The new guidance provides greater clarity around identification of KAPs and other partners and staff in senior positions (OPSSs) for rotation purposes. The rotation database, which records details of how long partners and staff have been involved on audit engagements, was also upgraded by the firm in late 2007.

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<sup>12</sup> APB Ethical Standard 3, paragraphs 5,6,12 and 16

We met the business unit leaders to discuss the rotation monitoring procedures performed in the year and reviewed the upgraded database.

The rotation monitoring procedures and the integrity of the information in the rotation database improved in 2007, reflecting the firm's efforts in this area.

#### *Long association and key audit partners*

As at the end of 2007, the rotation database included KAPs on nearly all of the firm's FTSE 100 audits. There was an increase in the number of KAPs and OPSSs identified, compared with last year, mainly in other lines of service, which demonstrates that audit teams have responded positively to the changes in the firm's guidance in this area.

On large audits, it is not unusual for the group engagement partner to have previously been involved in the audit in other roles. On one listed audit reviewed by us the group engagement partner had been involved on the audit for 18 years in different roles.<sup>13</sup> The audit team informed us that the review by the QRP was considered by them to be the safeguard in relation to the familiarity threat arising. However, it did not appear any more rigorous than would otherwise have been the case. We believe that the safeguards adopted should be specifically responsive to the independent threats.

In our view the firm has comprehensive rotation policies and procedures, but some improvement is required as outlined above.

## **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.

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<sup>13</sup> Four years as group engagement partner. The other roles varied and included partner roles in divisions of the group.

### **2.4.1 Audit methodology**

PwC's audit methodology and guidance is developed on a global basis, and is 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 electronic 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 standard requirements, but the audit systems relating to risk assessment do not easily facilitate compliance with the relevant requirements, as explained below.

Based on our review of individual audits, we comment below on those areas where improvement is required in relation to the application of the firm's audit methodology on audits.

### **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")<sup>14</sup>. A proper assessment of 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 document which records details of significant risks and the work planned and performed to address those risks. There was room for improvement on the majority of audits reviewed, with regard to the standard of completion of this document and compliance with aspects of the firm's risk assessment methodology. The specific issues varied between the audits concerned and related to aspects of one or more of the

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<sup>14</sup> International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108

following areas - recording the significance of risks (refer to the following paragraph), recording the linkage of risks to financial statement assertions (e.g. stock valuations) and recording and concluding on the assessment of controls over significant risks, as required by auditing standards<sup>15</sup>.

In a minority of audits reviewed there were audit risks which were described as significant risks, but the audit team subsequently informed us that they were not considered to be such. This made it more difficult for us to ascertain which were the significant risks requiring special audit consideration. In our view, the firm's requirement of only needing to explicitly assess risks between significant and non-significant was a contributing factor to the high number of risks categorised as significant on these audits. Risk assessment was covered in detail in the firm's 2007 audit training.

#### *Fraud risk assessment*

Auditing standards state that the auditor usually presumes that there is a risk of fraud in revenue recognition<sup>16</sup>, as it is an area which can be more prone to material misstatement arising from fraudulent financial reporting. In a minority of audits reviewed, the rationale for not classifying revenue recognition as a significant fraud risk was either not justified or was insufficiently explained on the audit files.

The majority of audits subject to our review did not identify revenue recognition as a significant fraud risk. This appears inconsistent with the firm's audit guidance, which states that only in limited circumstances should revenue recognition not be treated as a significant risk. The firm has agreed to issue further guidance in this area.

### **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

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<sup>15</sup> International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 113

<sup>16</sup> International Standard on Auditing (UK and Ireland) 240, paragraph 60

and the judgments relating to the extent of audit work performed. We were generally satisfied with the justification of the significant audit judgments, although there was some room for improvement in recording the justification of certain valuation related assumptions or the basis of provisioning on a small minority of audits.

#### *Audit plan and summary of evidence*

The firm requires audit teams to summarise the planned audit approach in a separate document, 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 was not accurately summarised for one of the material areas of the financial statements, typically revenue. In these cases, the actual audit approach sometimes differed from that planned, without explanation, and it was sometimes difficult to determine the actual audit approach based on the audit files alone. We did not raise any issues regarding the adequacy of the overall audit evidence in any of these cases; however, we only came to that conclusion after discussions with the audit teams. In our view, greater care should be taken to ensure that the audit plan and actual approach are clearly set out on the audit files, to support the basis of the audit approach undertaken.

#### *Substantive analytical review*

We identified issues on the majority of audits reviewed in relation to the quality of analytical procedures which were planned to obtain audit evidence (“substantive analytical review”), in one or more areas of the financial statements, particularly revenue. The firm’s audit methodology requires audit teams to follow specified procedures in performing this type of analytical review. However, audit teams often did not adequately follow one or more of those procedures. Whilst we did not raise an issue regarding the adequacy of the overall evidence in any of these cases, in a small minority of these cases improvements were required in the alternative procedures performed.

One of the matters covered in the firm’s 2007 audit training, which took place after these audits had been completed, was whether it is always appropriate to perform analytical review procedures of this type, especially where an independent expectation of a particular amount in the financial statements cannot be set by the audit team. We believe substantive analytical review needs to be a continued area of focus for improvement by the firm.

### *Trade debtor confirmations*

On a minority of audits, a sample of trade debtor balances had been circularised but not all responses had been received. We believe that more specific alternative procedures, as required by Auditing Standards<sup>17</sup>, should have been performed for those specific balances where no confirmation was received, to provide audit evidence over the accuracy of the debtor balances relating to those customers who had not responded.

### *Integrating the work of internal specialists*

The firm's internal specialists are often integrated into the audit, especially in the areas of tax and IT. We consider the firm's use of internal specialists in support of the audit of complex or specialised areas to be important. However, we found issues in relation to the recording of the work of internal specialists on half of the audits reviewed, mainly in relation to tax, where it was not possible to fully determine the planned audit approach to tax or the audit evidence obtained from the audit files alone. In a minority of cases, there were no audit working papers of the tax specialists on the audit files and the split of responsibilities between the tax specialists and the audit team was unclear from the audit files.

#### **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<sup>18</sup>. Such communications will usually take place with an Audit Committee, or similar body acting on behalf of the Board. 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")

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<sup>17</sup> International Standard on Auditing (UK and Ireland) 505, paragraph 31

<sup>18</sup> 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, the audit finalisation procedures were generally performed to a good standard.

8 December 2008

END OF REPORT

## **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

24 November 2008

Dear Sir,

**AIU public report on the 2007/8 inspection of PricewaterhouseCoopers LLP ('PwC')**

We appreciate the opportunity to respond to the AIU's public report on its 2007/8 inspection of PwC. We continue to support the objectives of the AIU.

We are pleased to note that your findings support the reliability of our audit opinions. PwC takes audit quality extremely seriously and we are therefore very pleased that this fact is recognised in the AIU report. Specifically you conclude in section 2 that '*PwC has demonstrated the importance it attaches to audit quality through its strategy, commitment to continual improvement and its related communications*', that '*...the firm has appropriate policies and procedures in place for its size and the nature of its client base...*' and that our '*...audit work was generally performed to a good or acceptable standard*'. However, we remain concerned that the tone and length of the report makes it difficult for a reader to understand this overall positive conclusion.

You have identified a number of detailed matters where you believe our policies or procedures, documentation or execution could be enhanced. We take your comments seriously and, as you know, these matters have been or are being addressed. We also continue to invest heavily in reinforcement and improvement and at any time have a number of programmes in place as part of our ongoing commitment to audit quality.

We are pleased to note that the public report on the firm issued in September 2008 by the Public Company Accounting Oversight Board of the USA, who adopt a scope and approach to inspection that is very similar to the AIU, and who had full access to your findings, had no matters to report.

We do not believe that your comments on the remuneration of 'key audit partners' and direct assistance by internal audit are consistent with ethical or auditing standards and we remain completely satisfied that we observe the principles involved. If it is the considered view of the AIU that existing standards or rules need to change then these matters should be referred to the Auditing Practices Board (APB) for their consideration as the standard setting body. We welcome the APB's current consideration of the use of internal audit in the external audit.

Yours faithfully



PricewaterhouseCoopers LLP

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