Audit Inspection Unit

Public Report on the 2011/12 inspection of PricewaterhouseCoopers LLP

15 June 2012

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

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1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the inspection of PricewaterhouseCoopers LLP ("PwC" or "the firm") carried out by the Audit Inspection Unit ("the AIU") of the Financial Reporting Council ("the FRC"), in respect of the year to 31 March 2012 ("the 2011/12 inspection"). Our inspection was conducted in the period from April 2011 to January 2012 (referred to as "the time of our inspection"). The objectives of our work are set out in Appendix A.

Our inspection comprised reviews of individual audit engagements and a review of the firm's policies and procedures supporting audit quality.

We reviewed 14 audit engagements undertaken by the firm in our 2011/12 inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between 30 June 2010 and 31 March 2011. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit.

Each year we select a number of areas of particular focus. For 2011/12, these were: group audit considerations; the fair value measurement of assets and liabilities; the impairment of assets (including goodwill and other intangibles); the evaluation of going concern; revenue recognition; related parties and the quality of reporting to Audit Committees.

In addition, we undertook two follow-up reviews to assess the extent to which our prior year findings on those audits had been addressed in the following year's audit.

Our review of the firm's policies and procedures supporting audit quality covered the following areas:

Tone at the top and internal communications
Transparency report
Independence and ethics
Performance evaluation and other human resource matters
Audit methodology, training and guidance
Client risk assessment and acceptance/continuance
Consultation and review
Audit quality monitoring
Other firm-wide matters

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. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

Further information on the scope of our work and the basis on which we report is set out in Appendix A.

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

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

The AIU acknowledges the co-operation and assistance received from the partners and staff of PwC in the conduct of the 2011/12 inspection.

1.2 Background information on the firm

The firm is a UK limited liability partnership and is the UK member firm of the PwC global network. The firm operates from 36 offices in the UK through 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.

For the year ended 30 June 2011, the firm's turnover was £2,461 million, of which £909 million related to the Assurance line of service. The firm had 864 partners, of whom 216 were authorised to sign audit reports, and 136 employees (audit directors) who were authorised to sign audit reports[1].

The AIU estimates that the firm audited 458 UK entities within the scope of independent inspection by the AIU as at 28 February 2011. Of these entities, AIU records show that

[1] As disclosed in the annual return to the ICAEW as at 31 December 2011.

206 had securities listed on the main market of the London Stock Exchange, including 37 FTSE 100 companies and 63 FTSE 250 companies.

Audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area are subject to inspection by the AIU under separate arrangements agreed with the relevant regulatory bodies and the principal findings of any such reviews undertaken in the year are included in this report. Our records show that the firm has 10 such audits, including one FTSE 100 company and three FTSE 250 companies.

1.3 Overview

We focus in this report on matters where we believe improvements are required to safeguard and enhance audit quality. We set out our key messages to the firm in this regard in Section 1.4. While this report is not intended to provide a balanced scorecard, we highlight certain matters which we believe contribute to audit quality, including the actions taken by the firm to address findings arising from our prior year inspection.

The firm places considerable emphasis on its overall system of quality control and has appropriate policies and procedures in place for its size and the nature of its client base in most areas that are subject to our review. Nevertheless, we identified certain areas where improvements are required to those procedures, as set out in this report.

Our file review findings, as set out in Section 2, largely relate to the application of the firm's procedures by audit partners and staff, whose work and judgments ultimately determine the quality of individual audits.

1.4 Key messages

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

- Ensure an appropriate level of professional scepticism is exercised in the audit of goodwill and other intangible assets and plant, property and equipment.

- Ensure appropriate involvement by group auditors at the planning stage in component auditors' risk assessments and planned procedures as well as at the completion stage in the evaluation of the sufficiency and appropriateness of their work for group audit purposes.

- Ensure the nature and extent of threats to the firm's objectivity and independence arising from non-audit services provided to audited entities and related safeguards are reported to Audit Committees.

- Ensure the partner performance appraisal process is improved, in particular that partners evaluate their performance against audit quality-related objectives.

- Ensure there is no adverse impact on audit quality as a result of the firm's initiatives to improve audit efficiency in the light of competitive pressures.

2 Principal findings

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

2.1 Review of audit engagements

Follow-up of audits reviewed in the prior year

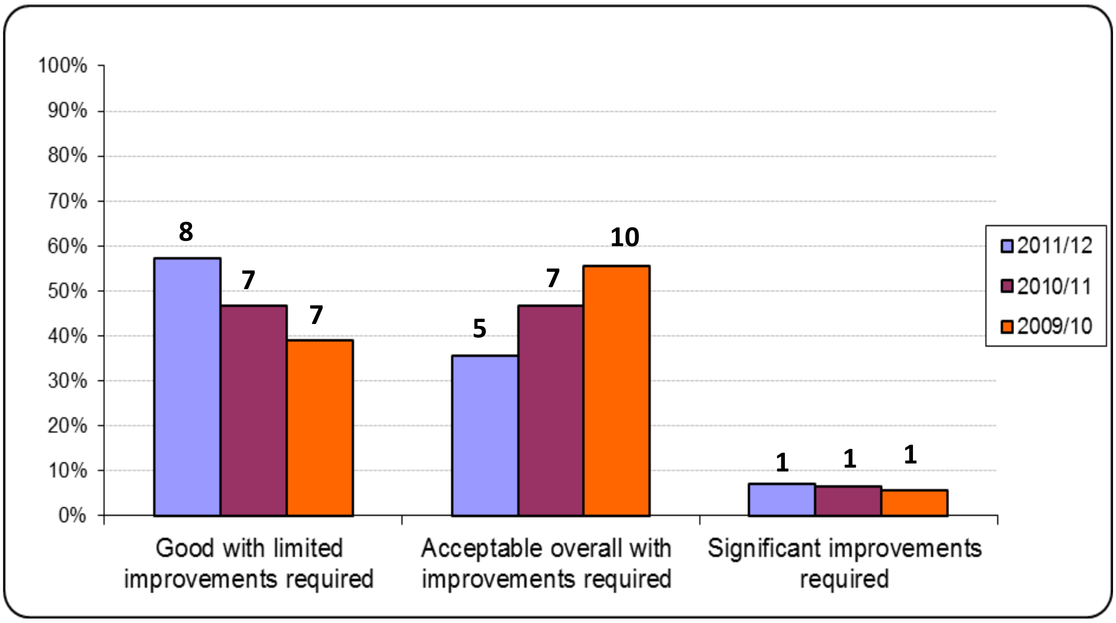
We undertook two follow-up reviews of audits we reviewed in the prior year. The issues we raised in the prior year were addressed on these audits resulting in improvements to audit quality in the relevant areas.

Audits reviewed in the current year

We reviewed and assessed the quality of selected aspects of 14 audits (2010/11: 15). Eight of the audits we reviewed (2010/11: seven) were performed to a good standard with limited improvements required; five audits (2010/11: seven) were performed to an acceptable overall standard with improvements required; and one audit (2010/11: one) required significant improvement in relation to the sufficiency of audit evidence for several key aspects of the audit.

An audit is assessed as requiring significant improvement if the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgments in one or more key audit areas, or the implications of concerns relating to other areas are considered to be individually or collectively significant. This assessment does not necessarily imply that an inappropriate audit opinion was issued.

The bar chart below shows the percentage of the audits we reviewed in 2011/12 by AIU grade with comparatives for 2010/11 and 2009/10.



Changes to the proportion of file reviews falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review, changes to the AIU's areas of particular focus and the scope of the individual reviews. For this reason and because of the small size of the samples involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Findings in relation to audit evidence and judgments

The focus of our reviews was on audit evidence and related judgments for material areas of the financial statements and areas of significant risk.

We draw attention to the following findings which the firm should ensure are adequately addressed in future audits:

- <u>Group audit considerations</u>
  Auditing Standards effective from December 2010 financial year-ends introduced more specific requirements concerning the conduct of group audits. We reviewed this area in nine audits, all of which were of FTSE 350 entities with significant overseas operations.

  In six cases, there was insufficient evidence of involvement by the group auditors at the planning stage in the component auditors' risk assessments and planned procedures. In two of these cases, there was also insufficient evidence of the evaluation at the completion stage of the sufficiency and appropriateness of the component auditors' work for group purposes. In a further case, there was insufficient explanation of the basis for the decision not to undertake full scope audit procedures for some components.

- Fair value measurement of assets and/or liabilities
  The firm's audit of the fair value measurement of assets and/or liabilities was generally performed to a good or acceptable standard. However, in one case concerning the valuation of financial assets, the audit team did not evaluate sufficiently the reasonableness of "consensus" valuations that were used or the approach adopted by the entity's management to the fair value hierarchy classification.

- Plant, property and equipment
  We identified weaknesses in the audit of property, plant and equipment (PP&E) in three audits. In one of them, a high street retailer, management's sensitivity testing comprised increasing sales only. Given the changing commercial environment in the high street, the audit team should have requested management to perform some downside testing on sales. In this respect, it did not demonstrate sufficient scepticism regarding the sensitivity testing of PP&E.

- Evaluation of an entity's 5-year business plan
  One audit required significant improvement in relation to the sufficiency of audit evidence for several key aspects of the audit.

  The audit team's evaluation of the entity's 5-year business plan was fundamental to the impairment review of goodwill and PP&E and the recognition of a deferred tax asset. It also contributed to its evaluation of going concern. However, given the significance of the plan to important areas of the audit, there was insufficient evidence to support the audit team's conclusion that the key assumptions underpinning the plan were reasonable. In addition, in its evaluation of going concern, the audit team did not give sufficient consideration to the need for going concern disclosures in the financial statements and the implications for the firm's audit report.

Recurring findings from one year to the next

In response to our prior year findings, the firm took steps to achieve improvements in the following areas in which recurring findings arose.

- <u>Goodwill and other intangible assets</u>
  The firm's audit of goodwill and other intangible assets was generally performed to a good or acceptable standard. However, the audit requiring significant improvement was an exception to this and, in a further audit, there was insufficient evidence to support the level of internally generated costs capitalised in the year.

- <u>Communicating with Audit Committees</u>
  The firm's communications with Audit Committees were generally timely and of a good standard. In particular, there was generally good linkage between the significant risks identified at the planning stage of audits and the reporting of audit findings to Audit Committees.

  However, in two cases unadjusted misstatements were not reported and, in two cases, aspects of the audit plan and/or audit findings were not communicated sufficiently.

  Further, in nine cases, there was insufficient reporting to Audit Committees of the nature and extent of threats to the firm's objectivity and independence arising from non-audit services provided to audited entities and the related safeguards that were applied.

Other findings in the current year

Quality control and audit finalisation

The firm's quality control and audit finalisation procedures were generally performed to an acceptable standard. Nevertheless, in three audits, there was insufficient evidence of involvement by engagement quality control review partners. In two other cases, there were weaknesses in the audit of financial statement disclosures.

Materiality

In two audits, an inappropriate level of materiality was applied to specific areas of the audit. One of these related to the audit of a pension scheme in which, in accordance with the firm's policy, the materiality used for the audit of the scheme's financial statements was also used for the audit of contributions for the purposes of the Auditors' Statement about Contributions. The firm accepted that this was inappropriate and has amended its policy in this area in response to our finding.

2.2 Review of the firm's policies and procedures

The firm puts significant resources into the application and monitoring of its policies and procedures, which are largely developed globally. This is achieved through its central functions which include partners and staff responsible for the implementation of the firm's audit system, technical training, audit quality monitoring, risk management, regulatory compliance and human resources.

The firm requires technical pre-issuance reviews to be carried out for the financial statements of all its FTSE 350 audits, higher profile audits and all new audits. The technical reviews for FTSE 100 and higher profile audits are carried out by the firm's central technical team. Those for FTSE 250 and new audits are carried out by reviewers in the business units.

During the year, the firm introduced a number of improvements to address weaknesses that we identified in the prior year. These included the following:

- <u>Professional scepticism</u>
  The firm introduced a requirement for audit teams responsible for the firm's higher profile audits to demonstrate how professional scepticism was applied on those audits. In addition, the firm provided training on professional scepticism for partners and staff responsible for the audit of such entities. The firm should continue to implement initiatives that will help embed the application of professional scepticism into the culture of the audit practice.

- <u>Partner training</u>
  The firm introduced a mandatory half-day training event for partners responsible for the firm's higher profile audits covering themes arising from file reviews in the AIU's 2011/12 inspection. The firm should consider extending training of this sort to all audit partners and directors.

We identified certain areas for improvement, as outlined below, which need to be addressed.

Findings in the current year

Focus on audit quality

During the year, the firm launched its Audit Transformation programme, the stated objective of which is to enable audit teams to focus on key judgment areas, standardise the firm's approach and improve audit quality. However, the guides issued to date under the programme appear to focus on improving audit efficiency by reducing audit hours. The programme also includes increasing the use of the firm's off-shoring capability, now through two overseas centres, one in India and the other in Poland. Work performed in 2011 by these centres accounted for about 4% of the firm's core audit hours and is expected to increase to 6% in 2012.

The firm's strategy for the forthcoming financial year identified quality as a key performance goal; however, the firm continues to focus on growing the business and achieving efficiencies in the conduct of audit work. The firm should ensure that there is no adverse impact on audit quality as a result of its initiatives to improve audit efficiency in the light of competitive pressures.

Annual independence confirmations

Partners and staff were required to submit their 2011 independence confirmations by 31 May 2011. As at 30 November 2011, there were outstanding matters in relation to approximately 80 confirmations. We were informed that one of these related to a partner. The outstanding matters should have been followed-up on a timely basis.

Tracking complex independence queries

The firm's current system for tracking independence queries does not allow those giving rise to multiple enquiries to be tracked appropriately. This means there is no central record of the resolution of complex independence queries which increases the risk that conflicting or inconsistent advice may be given. We were informed that the firm is proposing to implement a new system by the end of the first quarter of 2013.

Approval of contingent fees

The firm has policies and procedures in place requiring the proposed provision of non-audit services to an audited entity on a contingent fee basis to be communicated to the audit engagement partner and the Ethics Partner. In practice, however, the approval of contingent fee arrangements is delegated by the Ethics Partner. Given that contingent fee arrangements for non-audit services are not permitted under the Ethical Standards in certain circumstances, the firm's policies should require the Ethics Partner either to approve all such arrangements personally or to monitor on a regular basis any approvals given by others, so as to ensure they do not breach the prohibition on such arrangements.

Engagement quality reviews

We reviewed the output of the firm's 2011 engagement quality reviews and noted that, in relation to those identified as having adverse overall findings, there was not always evidence of an assessment of the appropriateness of the audit opinion and whether any action needed to be taken in this regard.

Impact of quality on remuneration

Engagement partners responsible for audits identified by internal or external quality reviews as having adverse overall findings are held accountable with implications for their remuneration. However, partners responsible for carrying out the engagement quality control reviews of such audits are not held accountable for the proper performance of their role.

Staff performance evaluation

We reviewed the self-appraisal forms and objectives for a sample of audit directors and managers. Approximately half of the appraisal forms in the sample had little or no comments on audit quality or from the appraiser. In addition, approximately a quarter of the appraisal forms and objectives for the following year were signed off after the due date.

Partner performance evaluation

We reviewed a sample of performance appraisals for partners responsible for audit engagements. In a large majority of cases, partners did not evaluate their performance against audit quality-related objectives. The firm should take steps to ensure the partner performance appraisal process is improved in this regard.

Partner promotions

We reviewed the supporting evidence for the majority of the candidates put forward by the audit practice for admission to the partnership with effect from 1 July 2011. Audit quality considerations were not addressed directly, although some candidates addressed them indirectly through the inclusion of past appraisal forms.

Andrew Jones
Director of Audit Quality
Audit Inspection Unit
FRC Conduct Division
15 June 2012

Appendix A – Objectives, scope and basis of reporting

Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.

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

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

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

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 but within the scope of audit regulation in the UK. Their work, which is overseen by the FRC, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

Basis of reporting

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 which the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including PwC annually. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's report to the ARC, which was finalised in April 2012, 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. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

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. 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 may therefore apply equally 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.

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 may be a significant period of elapsed time between completion of the AIU's inspection fieldwork at a firm and the publication of a report on the inspection findings.

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

Purpose of this report

This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice.

To the full extent permitted by law, the FRC and its employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

Appendix B – Firm's response

Andrew Jones
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7 June 2012

Dear Andrew.

Response to AIU's Public Report on the 2011/12 inspection of PricewaterhouseCoopers LLP

We appreciate the opportunity that you have given us to respond to the AIU's report and findings in respect of its 2011/12 visit to PricewaterhouseCoopers LLP ('PwC').

Quality is at the very heart of what we do: it is essential to our reputation, important to the work that we undertake for our clients and is a fundamental strategic objective for the firm. We therefore welcome your report and the findings noted during your inspection process. Such insights, observations and recommendations are an important contribution to helping us focus on and deliver continuous quality improvement.

As in previous years we remain committed to addressing the issues that you have identified during your review. We have already completed several of the agreed actions in response to the issues that you have raised and plan to implement the remainder of the detailed action plan that we have agreed with you over the coming months.

Yours sincerely

James Chalmers

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