

# TRANSPARENCY REPORTING BY THE LARGEST UK AUDIT FIRMS COMMENTARY ON 2008 REPORTS.

*Note by the Professional Oversight Board*

## Introduction

We are encouraged that seven of the ten largest UK audit firms<sup>1</sup> published separate transparency reports for 2007/2008 on a voluntary basis, ahead of the UK statutory requirement taking effect. We believe that transparency reports are an important mechanism for auditors of public interest entities to communicate to interested parties information about themselves, particularly their approach to audit quality.

Against this background, we thought that it would be useful to

- give some analysis of the information in these initial reports,
- indicate where we consider that the reports fall short of the requirements for statutory reports, and
- put forward points that we would like the relevant firms to consider carefully in finalising their 2009 Reports.

We have no wish at this stage to make detailed comparisons between transparency reports; nor, it should be emphasised, is our aim to press audit firms to follow a prescriptive template.

We are pleased to see that for the most part the firms have sought to meet the spirit as well as the letter of these requirements. Whilst firms present the information somewhat differently, in the main they have also avoided the temptation to produce over glossy PR-style documents, in which useful information can be buried. However, there are significant differences in the approach firms have followed and in the extent of transparency provided. We hope therefore that firms, in finalising their 2009 statutory transparency reports, will respond positively to the points raised in this note.

We set out in the *Annex* a simple analysis of the information firms have provided against each statutory requirement.

We draw out in the *Commentary* section below the principal points we want firms to consider in relation to specific statutory requirements. In particular, when we published

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<sup>1</sup>The seven firms are: [BDO Stoy Hayward LLP](#), [Deloitte & Touche LLP](#), [Ernst & Young LLP](#), [Grant Thornton UK LLP](#), [KPMG LLP](#), [Mazars LLP](#), [PricewaterhouseCoopers LLP](#) (Clicking on the firm's name should take you to their transparency report).

the statutory requirements for transparency reports in 2008, we noted that the *Audit Quality Framework*, published by the FRC in February 2008, provided a helpful framework for presenting information on audit quality. We encouraged firms to make full use of the drivers and indicators in preparing their transparency reports. We comment on the extent to which the firms have responded to this.

We also note that the **Audit Commission**, whilst not subject to the new statutory requirement, decided that it should comply with the POB Regulations on a voluntary basis. It published in December 2008 an *Annual Quality Report* on its Audit Practice to provide assurance to stakeholders as to the arrangements it has in place to ensure audit quality and to enable stakeholders to compare its audit practice with the major audit firms and other audit agencies. This report gives considerable detail on their approach to audit quality and how they work to achieve it. Whilst there are significant differences in the position of the Audit Commission and of the audit firms, audit firms required to prepare transparency reports might find it helpful to look at the way in which the Audit Commission has approached this. We should emphasise, however, that it is not our role to suggest that audit firms should follow this or any other specific approach.

We recognise that it is still early days and we would welcome further comments and suggestions from audit firms, and other relevant parties, on what information should be included in transparency reports. Comments should be sent to John Grewe ( [j.grewe@frc-pob.org.uk](mailto:j.grewe@frc-pob.org.uk) ). We will consider in the light of comments received whether it would be helpful to provide further guidance.

## Background

Most large audit firms with public interest clients agreed in 2003 to publish transparency reports on a voluntary basis to meet a recommendation from Government, following its review of audit regulation in the wake of auditing scandals in the US such as at Enron and WorldCom. At that time, most of the relevant firms met this recommendation by adding material to their Annual Reports

The Statutory Audit Directive, agreed in 2006, introduced a mandatory requirement for annual transparency reporting by auditors of UK companies with securities admitted to trading on a UK regulated market. In the UK, effect to this was given through the *Statutory Auditors (Transparency) Instrument 2008*, published by the Oversight Board, following consultation, in April 2008. It applies in respect of any financial year of a relevant audit firms starting on or after 6 April 2008.

## **Points for firms to consider arising from 2008 Reports**

### **Description of the network and the legal and structural arrangements of the network**

There are differences in the extent of the information given about the network arrangements, with in some cases very little information on the structure of central Boards or committees and their functions. In general we consider that the reports would be more transparent were there a fuller statement of the obligations and undertakings of the firm under the agreement for membership of the network.

### **Governance structure of the UK audit firm**

In some cases the description of the UK governance structure is restricted to the main Management Board and a committee of elected partners. Other transparency reports give more detail on the structure, including for example on the role of various sub-committees of the Board. We consider that those firms giving the fuller picture provide the better model.

### **Description of Internal Quality Control Systems**

This is a key element within the reports. Most firms, using either the ISQC1 structure or broadly comparable headings, give detailed information on the procedures and practices designed to deliver high quality audits. However, one firm says little more than that its quality control systems cover the six elements required by International Standard on Quality Control (ISQC) 1. Again we consider that the fuller presentation provides the better model. Whilst the minimalist approach arguably meets the legal requirement, in our view it falls well short of meeting the spirit of transparency reporting.

### **Use of the FRC's Audit Quality Framework**

Three firms refer explicitly in their reports to the use they have made of the *Audit Quality Framework (AQF)*. One of these firms comments against each driver identified in the AQF. It is also clear one further firm has prepared its transparency report with the AQF drivers and indicators very much in mind, even though there is no specific reference. The use of the AQF is less obvious in the other reports, though, in two of these reports, there are comments on some of the drivers and related indicators.

Overall, the use made of the *Audit Quality Framework* is patchy. Whilst we recognise that there is much in common between the Framework and the requirements of ISQC1 - and we do not want to see repetition within a report - we consider that it would be helpful if all reports showed clearly and systematically the steps the firm takes to achieve audit quality, by reference to the drivers and related indicators. In particular, taken overall the

reports were relatively weak in commenting on the indicators of audit quality relating to the skills and personal qualities of audit partners and staff, and on the indicators of audit quality relating to the reliability and usefulness of audit reporting.

#### Statement on the Effectiveness of the Functioning of the Internal Quality Control System

It is difficult to find a statement in any transparency reports that unequivocally meet this requirement. The closest is the comment by one firm that it has taken or is taking the “necessary actions to remedy any significant failings or weaknesses identified in the review [of quality]”. We would expect to see a clear statement in transparency reports to meet this requirement.

### **Independence Procedures**

#### Confirmation that an internal review of independence practices has been conducted

There is no explicit confirmation in any of the reports that the firm has conducted an internal review of independence practices. Only one firm comments explicitly under this heading. However, all the firms comment on their monitoring of compliance with independence requirements, for example by auditing a sample of partners’ personal investments. Whilst the statutory requirement does not set a time scale for such an internal review, we would expect a clear statement in transparency reports to meet this requirement.

### **Financial Information, including information on the importance of the auditor’s statutory audit work.**

One firm notes, quite reasonably, that there is no detailed guidance to audit firms on what financial information should be provided in transparency reports. Our preliminary view, in the light of the information firms have provided in these reports is that **all** firms required to publish a transparency report should provide the following financial information:

- Total revenues, broken down to show revenues from statutory audit work<sup>2</sup>, from non-audit services provided to audit clients, and from non-audit services to non-audit clients.
- Comparative figures for the previous year.

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<sup>2</sup> We suggest that firms use the definition of “work on statutory audit and directly related services” in the CCAB Voluntary Code of Practice on the Disclosure of Audit Profitability – see footnote 3 below.

- An analysis of the types of non-audit services provided to audit clients. There is a separate statutory requirement on firms that are LLPs or limited companies to provide such an analysis in their accounts but we consider that it would be helpful to include this also within the transparency report.

In addition, those audit firms within the scope of the Voluntary Code of Practice on Disclosure of Audit Profitability<sup>3</sup> should consider whether to include in the Transparency Report the information on audit profitability required under the Code. The Code states that the reporting firm should make the disclosure either in its Annual Report or in its Transparency Report.

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<sup>3</sup> The Consultative Committee of Accountancy Bodies published the *Code* in March 2009. It was developed at the request of the FRC and in response to one of the recommendation of the Market Participants' Group aimed at increasing choice in the audit market. The firms within scope of the Code are those firms subject to full-scope inspection by the Audit Inspection Unit. .

## 2008 Transparency Reports published by the seven of the ten largest UK audit firms

## Analysis of information provided in the reports under each heading.

<b>1. A description of the legal structure and ownership of the UK audit firm.</b>	
(a) Legal form and where incorporated	All firms provide this.
(b) Who owns the firm	All firms provide this.
(c) Number of partners/members	A minority of firms include this.
(d) Related firms in UK	3 firms comment on related UK firms. However, such information may not be relevant for all the firms.
(e) Number of offices in the UK	1 firm provides this.
(f) Whether firm has branches outside the UK; and if so information on them.	1 firm comments on this. However, this may not be relevant for other firms
(g) List of principal business lines	Most firms list their main lines of business.
<b>2. Where the UK audit firm belongs to a network, a description of the network and the legal and structural arrangements of the network.</b>	
(a) Name of network to which firm belongs	All firms provide this.
(b) Name and legal form of central organisation	All firms provide this.
(c) Size of network in terms of revenues, number of offices, countries and employees	Most firms give some indicators of size; though not all for example include revenues
(d) Name of Network Central Body/Governing Body and related Boards and relationships between them.	Information on the governance structure of the network is patchy. Whilst in some cases the information is very limited
(d) How appointments are made to Central Body/Governing Body and related Boards.	With two exceptions there is little or no information on this.
(e) Functions of Central Body/Governing Body and related Boards	Most firms give some information on this.
(f) Frequency of meetings of Central Body/Governing Body and related Boards	There is little information on this.
(g) Key features of the Member Firm Network agreement including extent of	Firms give very little or no information on this.

profit sharing arrangements	
<b>3. A description of the governance structure of the UK audit firm.</b>	
(a) Names of principal management bodies and committees and relationship between them.	All firms give information on this; some significantly more than others
(b) Names of partners on principal management body	Most firms provide this.
(c) Relationships between the management bodies	All firms give information on this.
(d) How membership of principal management bodies and committees is determined.	All firms give information on this.
(e) Functions of principal management bodies and committees	All firms give information on this.
<b>4. A description of the internal quality control system and a statement on the effectiveness of its functioning</b>	
(a) Leadership responsibilities for quality within the audit firm (b) Ethical Requirements (c) Acceptance and Continuance of client relationships and specific engagements (d) Human Resources (e) Engagement Performance of Audits (f) Monitoring	Three of the six firms structure their descriptions of the internal quality control system under these headings, taken from ISQC1; three firms use different presentations and headings but cover more or less the same ground. These firms give considerable detail on all these elements. One firm notes that its quality control system covers the six elements required by ISQC1 but gives little further information.
Use of the FRC's <i>Audit Quality Framework</i> to show how firm ensures audit quality	Three firms make an explicit reference to the FRC's <i>Audit Quality Framework</i> and provide comments against the specific drivers. A further firm does not make an explicit reference but has clearly paid close regard to the <i>AQF</i> in writing its Transparency Report.
Statement on the effectiveness of the functioning of the internal quality control system	No firm gives a statement that unequivocally meets this requirement. Only one firm makes a statement under this heading, though this is cast in terms of

	a commitment to the membership requirements of the Forum of Firms on quality control standards, policies and methodologies. Another firm comments that “necessary actions have been or are being taken to remedy any significant failings or weaknesses identified in the review [of quality]”.
<b>5. A statement of when the last external monitoring of the audit firm took place.</b>	All the firms include this but do not go further and provide information on the outcome of the external monitoring. However, these reports predate public reporting on individual audit firms by the AIU, and we would expect the reports to include at least a link to any public reports on the firm.
<b>6 A list of public interest entities in respect of which an audit report has been made in the financial year of the auditor.</b>	Five firms include a list within the transparency report; two firms provide a cross reference to where the information is available on their web-site (as is allowed). There are differences in the basis of the list. 5 firms give the precise information required under 6; one firm lists list the relevant audit clients as at a particular date; and one cross refers to a list of current publicly listed audit clients.
<b>7. A description of the auditor’s independence procedures and practices including a confirmation that an internal review of independence practices has been conducted.</b>	
Description of independence procedures and practices	All the firms provide a description but there are substantial differences in the level of detail provided.
Confirmation that an internal review of independence practices has been conducted.	Only one firm makes a statement under this heading, commenting that “independence policies and procedures are under constant review ... and have been reviewed and updated in the last twelve months to take account of [new

	regulatory and professional developments]” All the firms indicate that they monitor compliance with independence requirements, for example by auditing a sample of personal investments of partners and managers. It is doubtful however, that a reference to monitoring compliance equates to an “internal review of independence practices”.
<b>8. A statement on the policies and practices designed to ensure that auditors continue to maintain their theoretical knowledge, professional skills and values at a sufficiently high level.</b>	All firms provide information on their arrangements to ensure that auditors maintain competence. In some cases this is included as a separate section; in others it forms a part of a wider section on Audit Quality.
<b>9. Financial information, including the showing of the importance of the auditor’s statutory audit work.</b>	
Total Revenues	All firms provide this.
Revenues from statutory audit work	All firms provide this.
Revenues from non-audit services for audit clients	All firms provide this.
Revenues from non-audit services to non-audit clients	All firms provide this.
Further analysis of non-audit services to audit clients	No firm provides this information. Although this should be provided separately in the statutory report and accounts for LLPs or plcs, we consider that it would be helpful to provide such an analysis in the transparency report.
Comparative Information for previous year.	4 firms provide comparative information for the previous year.

<b>10. Information about the basis for the remuneration of partners.</b>	
List of criteria for remunerating partners/members/elements of partner remuneration	All the firms either give some explanation of the elements that go to make up partner remuneration or list the criteria that are taken into account in determining remuneration. Only one firm, however, gives an indication of the relative importance of the different elements or criteria.
Confirmation that audit partners not remunerated by ref to sale of non audit services to audit clients	Five of the firms provide explicit confirmation of this.

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