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VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

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VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

Voluntary Code of Practice on Disclosure of Audit Profitability, published in March 2009 by the Consultative Committee of Accountancy Bodies.

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INTRODUCTION

Reasons for issuing the Code of Practice

- IN1 In October 2006, the Financial Reporting Council (FRC) established a Market Participants Group (MPG) to provide advice in relation to its Choice in the UK Audit Market project. In particular, the MPG was tasked with identifying and assessing actions that market participants might take to mitigate risks arising from the characteristics of the market for the audit of major public interest entities in the UK.
- IN2 The MPG published its Final Report in October 2007. Recommendation 2 stated that 'Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.' The Chief Executive of the FRC then invited the Consultative Committee of Accountancy Bodies (CCAB) to develop guidance to audit firms on the voluntary disclosure of this information. The CCAB established a Working Group under the Chairmanship of Andrew Vials, Chairman of the CCAB Limited Liability Partnerships Statement of Recommended Practice Steering Group, to develop a Voluntary Code of Practice.

Main features of the Code

- IN3 In enlisting the support of the CCAB in developing guidance, the FRC suggested that 'the information that would be disclosed on a voluntary basis would differ from existing published information in terms of the range of services for which financial results are reported and the treatment of indirect costs.' The Code therefore sets out to establish a basis for comparable reporting of audit profitability by defining the audit segment (the 'reportable segment') and suggesting some principles designed to achieve more comparable and consistent treatment of costs relating to that segment.

Guiding principle

- IN4 Audit firms within the scope of the Code should disclose the financial results of their work on statutory audits and directly related services (the 'reportable segment') on a basis comparable with that of other firms, so far as is consistent with the guidance set out in this Code.

The reportable segment

- IN5 The FRC suggested that the information to be disclosed under the Code 'would relate to a narrower range of services than those under the heading 'Audit' or 'Assurance' in most large firms' segmental reporting' and that 'directly related services' should include work that fits naturally with the auditor's statutory responsibilities, as this would be the most relevant information to potential new entrants to the market.'
- IN6 Accordingly, the Code includes in the reportable segment fees in respect of:
- (a) any audit required by UK statute and required to be carried out in accordance with the APB's International Standards on Auditing (UK & Ireland) and other formal guidance; and
 - (b) other work that 'fits naturally' with the auditor's statutory responsibilities. This is work that is required to be carried out by the auditor or that in practice tends to be carried out by the auditor.

Overheads

- IN7 The FRC commented that 'there is a lack of consistency in how indirect costs are allocated to audit work in the firms' existing reporting. Methods vary from no allocation of indirect costs to all indirect costs being allocated. ... greater consistency in the allocation basis would make the information more comparable and hence more useful.'
- IN8 Accordingly, the Code states that overheads, as measured and recognised in the firm's financial statements, should be allocated to the reportable segment on an appropriate basis (which should be disclosed). It will generally be appropriate to allocate certain overheads by reference to staff numbers or costs, while more general methods of allocation may be more appropriate for other overheads.

VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

Scope

- 1. This Code of Practice applies to any UK audit firm that is a 'major firm' as determined by the Professional Oversight Board (POB).**
2. A major firm is a firm that performs more than ten major audits as defined in paragraph 13 of Schedule 10¹ to the Companies Act 2006. Paragraph 13 defines a 'major audit' as a statutory audit conducted in respect of -
 - (a) a public interest entity, or
 - (b) any other person in whose financial condition there is a major public interest.

The POB determines which entities fall into the category of a 'public interest entity'. Firms that perform more than ten major audits are subject to the arrangements for independent monitoring set out in paragraph 23 of Schedule 10 to the Companies Act 2006. Such firms are subject to a full-scope inspection by the Audit Inspection Unit.

Guiding principle

- 3. Major firms should disclose the financial results of their work on statutory audits and directly related services (the 'reportable segment') on a basis comparable with that of other firms.**

Definition of the reportable segment

- 4. Any audit required by UK statute and required to be carried out in accordance with the APB's International Standards on Auditing (UK & Ireland) and other formal guidance, and other work that 'fits naturally' with the statutory audit, should be included in the reportable segment.**
5. Examples of audits to be included in the reportable segment include:
 - Companies under the Companies Act;
 - Pension schemes;
 - Charities;
 - Friendly Societies;
 - Building Societies;
 - Open-Ended Investment Companies and Unit Trusts;
 - Lloyd's Syndicates;
 - Mutual Life Offices;
 - Public sector audits;
 - Housing Associations;
 - Limited Liability Partnerships.
- 6. In addition to fees for statutory audit work, the reportable segment includes fees for 'directly related services' - that is, work that 'fits naturally' with the**

¹ As amended by 'The Statutory Auditors and Third Country Auditors Regulations 2007' (SI 3494/2007).

auditor's statutory responsibilities. This is work that is required to be carried out by the auditor or that in practice tends to be carried out by the auditor.

7. Typical examples of directly related services include:
- pieces of accounting advice incidental to the audit;
 - regulatory reporting such as letters or reports under the Listing Rules;
 - review and approval of preliminary announcements;
 - review of interim financial information;
 - solvency reports;
 - statutory or regulatory reporting on internal controls, including Sarbanes-Oxley attestation work;
 - work for an overseas parent in relation to a branch or in relation to group accounts but not involving a UK statutory audit.
8. Examples of services that would normally be excluded from the reportable segment include:
- consultancy services;
 - due diligence;
 - environmental audits;
 - internal audit;
 - non-regulatory reporting on internal controls;
 - one-off major pieces of accounting advice;
 - stand-alone value-for-money engagements.

Revenue

9. **The basis for recognising and measuring revenue should be consistent with the firm's financial statements.**

Costs

10. **Direct costs and overheads should be recognised and measured on a basis consistent with that used for the firm's financial statements, and allocated to the reportable segment using appropriate bases, which should be disclosed. Accordingly, such amounts should be representative of actual costs rather than any notional amounts.**
11. The appropriate basis for allocating direct costs will normally involve reference to time records, taking account of internal recharges for non-audit staff, and making appropriate estimates. Methods such as simply applying a gross margin from a related but non-congruent business segment would not normally be appropriate.
12. It will generally be appropriate to allocate certain overheads by reference to staff numbers or costs, while more general methods of allocation may be more appropriate for other overheads.
13. Overheads allocated to the reportable segment will normally include:
- general management;
 - global network related costs;
 - insurance;
 - IT;
 - legal;

- marketing;
- office accommodation;
- practice support;
- technical support;
- training.

Information should be given about the costs that have been allocated to the reportable segment and a description of the basis on which they have been allocated, although it is not necessary to disclose these amounts separately.

14. Reporting firms should disclose the impact of material non-recurring income and costs, in order to highlight their effect on profitability.
15. **The basis of accounting for members' or partners' remuneration should be consistent with the firm's legal structure and financial statements.**
16. Where there is a non-discretionary contractual obligation to pay remuneration to a member or partner, such remuneration will be charged as an expense in the financial statements and allocated to the reportable segment. In other cases, members' or partners' remuneration will not be charged as an expense. The basis of accounting and the extent to which any members' or partners' remuneration has been allocated to the reportable segment should be disclosed.

Disclosure

17. **The reporting firm should disclose turnover and operating profit for the reportable segment, with a description of the basis on which these numbers are derived.**
18. Disclosure under the Code of Practice may be given either in the reporting firm's Annual Report or within the reporting firm's Transparency Report.²

Effective date

19. The Code of Practice becomes operative for accounting periods beginning on or after 6 April 2009. Earlier application is encouraged. Comparative figures are not required in the first period of reporting.

² See The Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008). Transparency Reports must be published within three months of the firm's year end.

BASIS FOR CONCLUSIONS

INTRODUCTION

- BC1 This Basis for Conclusions summarises the Consultative Committee of Accountancy Bodies' considerations in reaching its conclusions in developing the Voluntary Code of Practice on Disclosure of Audit Profitability.
- BC2 There is wide divergence in practice in the way audit firms report their results, particularly with regard to reporting different business segments and allocating overheads. The Code aims to achieve more comparable reporting of audit profitability. However, complete comparability is not considered achievable given the different business models and management structures of the firms, and so the Code consciously adopts a principles-based approach in order to minimise prescriptive rules and unduly costly systems changes by firms.
- BC3 The CCAB issued an exposure draft of the Code in September 2008. Eleven responses were received. The CCAB agreed with the two major issues raised by commentators and made corresponding changes to the proposals.
- (a) The scope was thought to be too wide in capturing some 40 firms, many of which might have only one qualifying audit client. The proposals were amended so as to bring only 'major firms' (ie, those with more than ten major audits) within the Code's scope. (See paragraph BC4 below.)
 - (b) Publishing the Code in March 2009 to be operative for periods commencing on or after 1 April 2009 was thought to leave too little time for firms to make the necessary systems changes. The operative date was therefore changed to 6 April 2009. (See paragraph BC14 below.)

A number of detailed suggestions were made, none of which was put forward by more than one or two commentators. These were generally either more prescriptive than the CCAB thought appropriate for a principles-based Code, which as noted above acknowledges that complete comparability is not practicable, or strayed from the relatively specific remit set out by the Financial Reporting Council.

Scope

- BC4 Under the proposals in the exposure draft, the Code would have applied to any UK audit firm that is a transparency reporting auditor under the Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008). This would have had the effect of bringing within the scope of the Code any statutory auditor that had reported on the annual accounts of an entity with securities traded on a regulated market at any time during the auditor's financial year. This would have captured approximately 40 audit firms, some of which audit only one such entity. Commentators pointed out that the requirements could be particularly onerous for smaller firms, particularly with regard to capturing the relevant information. They also pointed out that the smaller firms did not seem to be the main focus of the initiative promulgated by the FRC and other market participants.
- BC5 The CCAB agreed with these representations and accordingly amended the scope of the Code to apply only to 'major firms' - ie, firms with more than ten 'major audits'. Major audits are audits of public interest entities, as determined by the Professional Oversight Board (POB) for the purpose of applying the arrangements for independent monitoring of audits set out in paragraph 23 of Schedule 10 to the Companies Act

2006. A 'major firm' is subject to a full-scope inspection by the Audit Inspection Unit (AIU). In March 2009 there were nine major firms. The CCAB considers that, in the context of the underlying objectives of the Code, this is a more appropriate level of coverage than originally proposed. However, other firms with an interest in this sector of the market may also wish to consider compliance with the Code.

Reportable segment

- BC6 In accordance with the Market Participants Group's recommendations, the Code includes in the reportable segment fees in respect of any audit required by UK statute and required to be carried out in accordance with the APB's International Standards on Auditing (UK & Ireland) and other formal guidance. The list in paragraph 6 of the Code is not intended to be exhaustive.
- BC7 The Code also includes in the reportable segment fees in respect of work that 'fits naturally' with the auditor's statutory responsibilities - that is, work either required to be, or in practice tends to be, carried out by the auditor. The examples in paragraphs 7 and 8 of directly related services to be included in or excluded from the reportable segment are not intended to comprise comprehensive lists, and judgement will always be required in deciding what to include. The broad intention is to include work obtained necessarily or primarily as a result of the firm carrying out a statutory audit, but to exclude work that might equally be given to another firm.

Direct costs

- BC8 The Code makes it clear that direct costs should not normally be allocated by applying a gross margin from a similar business sector. The effect of adopting this approach would be to disclose numbers that, while not necessarily materially inaccurate, would represent notional rather than actual amounts that in most cases would be based on reporting of business sectors, which comprise a broader scope of services than the work that is the subject of this Code.

Overheads

- BC9 As noted by the FRC, audit firms are inconsistent in the way and to the extent that they allocate indirect costs to audit work in their published reports. To achieve greater comparability, the Code therefore states that overheads, as measured and recognised in the firm's financial statements, should be allocated to the reportable segment.

Material non-recurring items

- BC10 Material non-recurring costs have the potential to temporarily reduce profits in a particular period, making it difficult for users to assess the underlying profitability of the firm's statutory audit work and thus reducing comparability between reporting firms. Similar considerations apply to non-recurring income. The Code therefore calls for firms to highlight the effect on profitability of material non-recurring income and costs.

Members' and partners' remuneration

- BC11 Audit firms are typically partnerships or limited liability partnerships (LLPs). In a partnership, the profit figure is generally struck before taking into account any amounts of partners' remuneration. In an LLP, certain amounts due to members may be charged to the profit and loss account as expenses. Examples typically include

salaries, interest on capital balances and any profits automatically divided³. Clearly, a firm that has, for example, a high proportion of salaried partners would show a smaller profit in the financial statements than if it had no partners' salaries charged to profit and loss.

- BC12 Audit firms inevitably have different mixes of equity and salaried members, and different profit sharing arrangements. The Code calls for the basis of accounting for members' or partners' remuneration to be consistent with the firm's legal structure and financial statements, as this reflects the management approach of the firm and its business model. To some extent, this might make straightforward comparison of 'bottom line' profitability difficult. However, the LLPs SORP requires separate disclosure of any members' remuneration charged as an expense. In the case of LLPs, therefore, users will know the amount of profit before members' remuneration and profit shares, leading to greater comparability between firms.

Disclosure

- BC13 The CCAB discussed whether the information required in compliance with the Code should be presented in the reporting firm's Transparency Report or its Annual Report. On the one hand, the Code applies to major firms, which are all transparency reporting auditors. They are therefore already required to provide 'Financial information ... including the showing of the importance of the transparency reporting auditor's statutory audit work.' (paragraph 9, Schedule to POB 01/2008). On the other hand, the (minimum) information required for the Transparency Report is less extensive than that called for in the Code, and is required within three months of the year end. Mandating disclosure under the Code in the Transparency Report might therefore be onerous for some firms. The majority of commentators favoured retaining the flexibility proposed in the exposure draft, and so disclosure is therefore allowed in either the Transparency Report or the Annual Report.

Effective date

- BC14 The FRC acknowledges that 'some modifications to firms' cost allocation mechanisms might be necessary' in order to make disclosure under the Code. The CCAB agrees it is likely that firms will need to make systems changes in order to capture the necessary information. Such changes therefore need to be made before the start of the relevant accounting period. The CCAB agreed with commentators that publishing the Code in March 2009 to become operative for periods commencing on or after 1 April 2009 would leave too little time for firms to make the necessary systems changes, particularly in the case of firms with 31 March year ends. The operative date has therefore been changed to 6 April 2009. Disclosure under the Code is therefore required in respect of accounting periods beginning on or after 6 April 2009.

³ See the revised Statement of Recommended Practice on *Accounting by Limited Liability Partnerships*, published by the CCAB in 2006.