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Exposure Draft

VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

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Comments should be in Word format and sent by email to desmond.wright@icaew.com, to arrive by 31 December 2008.

Comments will be regarded as on the public record.

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VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

Draft Voluntary Code of Practice on Disclosure of Audit Profitability, published in September 2008 by the Consultative Committee of Accountancy Bodies, for comment by 31 December 2008.

CONTENTS	PARAGRAPH		
Introduction	IN1	-	IN8
Invitation to Comment			
Draft Voluntary Code of Practice on Disclosure of Audit Profitability			
Scope	1	-	2
Guiding principle			3
Definition of the reportable segment	4	-	8
Revenue			9
Costs	10	-	16
Disclosure	17		18
Effective date			19
Basis for conclusions	BC1	-	BC11

INTRODUCTION

Reasons for issuing the [draft] 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 for 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 [draft] 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 [draft] 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 [draft] 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 in this Code.

The reportable segment

- IN5 The FRC suggested that the information to be disclosed under the [draft] 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 [draft] 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 [draft] 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.

INVITATION TO COMMENT

The CCAB requests comments on any aspect of the draft Code. It would be helpful if respondents would specify the paragraph or paragraphs to which a comment relates, and support comments with reasons and, where applicable, preferred alternatives.

Some specific issues on which the CCAB would particularly welcome views are set out below.

Scope

The [draft] Code applies to any UK audit firm that is a ‘transparency reporting auditor’ - that is, a statutory auditor that has made an audit report on the annual accounts of one or more public interest entities at any time during the financial year of that statutory auditor.

Question 1: Do you agree that the proposed scope captures the appropriate firms to report in compliance with the [draft] Code?

Definition of the reportable segment

The [draft] Code includes in the reportable segment:

- (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.**

Question 2: Do you agree with the overall definition of the reportable segment?

Question 3: Do you agree that the examples in paragraph 5 of audits to be included in the reportable segment are appropriate? Should any examples be omitted, or are there other examples that should be included?

Question 4: Do you agree that the examples in paragraphs 7 and 8 of directly related services to be included in or excluded from the reportable segment are appropriate? Should any examples be omitted, or are there other examples that should be included?

Revenue

The [draft] Code states that the basis for recognising and measuring revenue should be consistent with the firm’s financial statements.

Question 5: Do you agree that this is the appropriate basis for recognising and measuring revenue? If not, why not, and what other basis would you suggest?

Costs

The [draft] Code states that 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.

Direct costs should not normally be allocated by methods such as simply applying a gross margin from a related but non-congruent business segment.

Overheads may be allocated by reference to staff numbers or costs, or by using more general methods, as appropriate. Reporting firms should disclose the impact of material non-recurring or 'lumpy' costs.

Question 6: Do you agree that direct costs should not normally be allocated by methods such as applying a gross margin from another business segment?

Question 7: Do you agree that overheads should be allocated to the reportable segment?

Question 8: Do you agree that the proposed guidance on allocating overheads achieves an appropriate balance between minimising prescription for preparers while achieving comparability between firms?

Question 9: Do you agree that reporting firms should disclose the impact of material non-recurring or 'lumpy' costs, in order to highlight their effect on profitability? Will the current guidance achieve sufficient comparability between firms, or is further guidance needed on the identification and disclosure of such costs?

Members' and partners' remuneration

The [draft] Code states that the basis of accounting for members' or partners' remuneration should be consistent with the firm's legal structure.

Question 10: Do you agree that the basis of accounting for members' or partners' remuneration should be consistent with the firm's legal structure, with disclosure of the basis and the extent of allocation to the reportable segment?

Disclosure

The [draft] Code allows disclosure in either the reporting firm's Annual Report or Transparency Report.

Question 11: Do you agree with the option to disclose in either the Annual Report or the Transparency Report?

Effective date

It is proposed that disclosure under the [draft] Code should be implemented in respect of accounting periods beginning on or after 1 April 2009.

Question 12: Do you agree with the proposals for the timing of implementation of the [draft] Code?

DRAFT VOLUNTARY CODE OF PRACTICE ON DISCLOSURE OF AUDIT PROFITABILITY

Scope

- 1. This Code of Practice applies to any UK audit firm that is a transparency reporting auditor under the Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008).**
2. A transparency reporting auditor is defined¹ as a statutory auditor that has made an audit report on the annual accounts of one or more public interest entities² at any time during the financial year of that statutory auditor.

Guiding principle

- 3. Transparency reporting auditors 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.

- 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 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.**

¹ Paragraph 2(1), Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008).

² ‘Public interest entity’ means an issuer –

- (a) whose transferable securities are admitted to trading on a regulated market; and
- (b) the audit of which is a statutory audit within the meaning of section 1210 of the [Companies] Act [2006];

(paragraph 1(4), Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008))

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. The basis of accounting for members' or partners' remuneration should be consistent with the firm's legal structure.**
14. 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 member or partner remuneration has been allocated to the reportable segment should be disclosed.

15. 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.

It is not necessary to disclose these amounts separately, but information should be given about the costs that have been allocated to the reportable segment and the basis on which they have been allocated.

16. Reporting firms should disclose the impact of material non-recurring or ‘lumpy’ costs, in order to highlight their effect on profitability.

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.³

Effective date

19. The Code of Practice becomes operative for accounting periods beginning on or after 1 April 2009. Earlier application is encouraged. Comparative figures are not required in the first year of reporting.

³ 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 [draft] 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 [draft] Code aims to achieve more comparable reporting of audit profitability. It consciously adopts a principles-based approach in order to minimise prescriptive rules and unduly costly systems changes by firms.

Scope

- BC3 The [draft] Code applies to any UK audit firm that is a transparency reporting auditor under the Statutory Auditors (Transparency) Instrument 2008 (POB 01/2008). This has the effect of bringing within the scope of the [draft] Code any statutory auditor that has reported on the annual accounts of a public interest entity at any time during the auditor's financial year. A 'public interest entity' is narrowly defined as one with securities traded on a regulated market. The effect is to capture approximately 40 audit firms, some of which audit only one public interest entity. The CCAB considered that, in the context of the underlying objectives of the Code, this is an appropriate level of coverage.

Reportable segment

- BC4 The [draft] 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 examples of relevant audits in paragraph 5 are drawn from the Public Oversight Board's list of 'Major Audits' for the purposes of audit inspection and the requirement for audit firms to notify new 'major audit' appointments to the relevant Audit Registration Committee¹. Public sector audits and housing association audits are given in the [draft] Code as further examples of audits that fall within the reportable segment. The list is not intended to be exhaustive.
- BC5 The [draft] 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

- BC6 The [draft] 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

¹ See <http://www.frc.org.uk/documents/pagemanager/pob/AIU%20Scope%202008-09.pdf>

reporting of business sectors, which comprise a broader scope of services than the work that is the subject of this Code.

Overheads

- BC7 As noted by the FRC, audit firms are inconsistent in the way they allocate indirect costs to audit work in their published reports. To achieve greater comparability, the [draft] 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 costs

- BC8 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. The [draft] Code therefore calls for firms to highlight the effect on profitability of material non-recurring or 'lumpy' costs.

Members' and partners' remuneration

- BC9 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 divided¹. 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.
- BC10 Audit firms inevitably have different mixes of equity and salaried members, and different profit sharing arrangements. The [draft] Code calls for the basis of accounting for members' or partners' remuneration to be consistent with the firm's legal structure, 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

- BC11 The CCAB discussed whether the information required in compliance with the [draft] Code should be presented in the reporting firm's Transparency Report or its Annual Report. On the one hand, the [draft] Code applies to transparency reporting auditors, who are 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 [draft] Code, and is required within three months of the year end. Mandating disclosure under the [draft] Code in the Transparency Report might therefore be onerous for some firms. Disclosure is therefore allowed in either the Transparency Report or the Annual Report.

¹ See the revised Statement of Recommended Practice on *Accounting by Limited Liability Partnerships*, published by the CCAB in 2006.

Effective date

BC12 The FRC acknowledges that ‘some modifications to firms’ cost allocation mechanisms might be necessary’ in order to make disclosure under the [draft] 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. Given the timetable for publishing the final Code (in the first quarter of 2009), it is proposed that disclosure under the [draft] Code should be implemented in respect of accounting periods beginning on or after 1 April 2009.