



PROMOTING AUDIT QUALITY – THE ABI’S RESPONSE TO THE FRC’S DISCUSSION PAPER

Introduction

- 1.1 In November 2006 the Financial Reporting Council (FRC) published a discussion paper addressing its objective of promoting and maintaining confidence in the audit process.
- 1.2 This is the response of the Association of British Insurers (ABI) whose members, as institutional investors in the securities of UK companies, have a strong interest in seeing an effective audit regime that underpins confidence in the veracity of the financial reports and accounts of issuers.

General Comments

- 2.1 Our Association welcomes the recognition by the FRC of the importance of this subject through its making this the first topic to be addressed in a number of discussion papers relating to its objectives. We have long argued that the FRC should take the lead in this important area. The paper is in general a balanced and sound survey of the issues that are relevant to the subject and we welcome the opportunity to comment.
- 2.2 We would emphasise our view that the overarching purpose and objective of financial reporting should be seen as the provision of a true and fair view for the benefit of shareholders and other users of accounts. It follows that the audit role must similarly be focused on that objective. The judgment of the auditor in confirming truth and fairness may, in turn, make important demands on both his professional faculties and integrity. This process is key to ensuring audit quality.
- 2.2 It is not always easy for investors to assess quality of audit, especially during favourable economic conditions when underlying problems are less likely to come to light. The difficulty is that lapses in quality only normally come to light when it is too late. This means that a quality culture from the outset is imperative.
- 2.3 Qualities of independence in the audit and the auditor are crucial but this is a dimension that receives insufficient attention in the paper. There is no substitute for professional integrity to stand firm against pressures that might compromise the auditor’s judgment but it is wrong that such pressures might be allowed to exist in the first place arising out of conflicts faced by the audit firm.
- 2.4 The changes flowing from the updating of the companies legislation that underpins statutory audit make this an opportune time to consider the subject. The clear requirement in law on auditors to give a true and fair assurance is of great importance in giving meaning to the audit opinion and,

in turn, confidence to investors. Less clear is the impact of changes introduced into the new Act regarding the need to assess whether the company has kept adequate as opposed to proper accounting records. Establishing what the precise requirements are and how they differ from those that previously applied represents unfinished business. It is vital that this is followed through.

- 2.5 We recognise that the increase in the prevalence of fair values under accounting standards represents a qualitative change to the perspective that auditors need to bring to bear and the scope of professional judgment. This is a challenge that should be embraced.

Specific Comments on the Consultation Questions

The Culture Within an Audit Firm

- Q1 Are there other important indicators of an audit firm's culture that are not referred to above?**
- Q2 Are there pressures that could compromise the culture of audit firms that have not been identified above?**
- Q3 Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?**

The importance of professionalism of its practitioners to ensuring the quality of the audit product can scarcely be overstated. However, there is an ever-present risk that this could be compromised by commercial objectives of the business in accountancy and related services undertaken by the firms within which audit professionals work.

Fostering of reputation is a prerequisite for long-term success in a properly competitive business environment. In the case of accountancy firms the quality and professionalism of what should be seen as the core discipline, that of audit, is key. It is disappointing how little prominence some of the largest accountancy firms give to their audit business in the way they present themselves to the outside world.

There is a distinct risk that firms that consider themselves as too big to be allowed to fail will place too little emphasis on safeguarding professional reputation. We suggest that a greater level of transparency from audit firms relating to their governance and internal controls would also help engender confidence by users of audited financial information.

The discussion paper gives insufficient attention to concerns about the extent to which incentivisation is wrongly tilted in practice. These concerns do not relate solely to the conflicts inherent in the provision of non-audit services. Within the audit business the incentivisation of partners and staff should be towards quality and not tilted towards simply generating an increase in audit fees. We are disturbed by the Audit Inspection Unit Public

Report of its 2005/6 Audit Quality Inspections which suggests that remuneration and career progression are insufficiently driven by audit quality considerations.

The Skills and Personal Qualities of Audit Partners and Staff

- Q4 Do you agree that technical skills, personal qualities and practical experience are key drivers to audit quality?**
- Q5 Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?**
- Q6 Should there be a fundamental review of the qualification and training requirements for auditors?**

Ensuring the right skill sets from both individual and collective perspectives is essential. High standards of training and development for those at an early stage in their career is needed so that professional competence is well engrained but this needs to be tempered by the value of wisdom and experience in more senior audit professionals such as the engagement partner. The discussion paper identifies that there is a risk that training may be focused on aspects of the firm's methodology rather than underlying principles and ethics of auditing. Action must be taken to avoid this.

The Effectiveness of the Audit Process

- Q7 Are there other factors that determine whether an audit process is effective?**
- Q8 Are there threats to the effectiveness of the audit process that have not been identified above?**
- Q9 Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?**

Audit standards are, evidently, a key aspect of the framework within which auditors work. These standards have undergone significant change in recent years as part of a process of global harmonisation but the FRC will be aware of concerns of investors that this may compromise standards in the UK.

The Reliability and Usefulness of Audit Reporting

- Q10 Are there other factors that determine whether audit opinions command confidence?**
- Q11 Are there other reasons why users may not have confidence in the audit opinion?**

Q12 Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?

Whether accounts provide a true and fair view is of fundamental importance to investors. The obligations placed, respectively, on directors and auditors to prepare accounts on this basis and to provide assurance regarding this, are therefore critical. The discussion paper is right to identify that some users and commentators have concerns about the audit process that in turn constitute a threat to confidence in audit reporting. Whilst welcoming the clarifications included in the Companies Act 2006 as regards the true and fair view we believe this should continue to be a matter of concern to the FRC and that efforts should be redoubled to ensure there is no erosion of this gold standard/ litmus test. Whether accounts provide a true and fair view is at the heart of the professional judgment of the auditor which makes crucial demands both of his integrity and competence.

Improved matters of emphasis reporting has the potential to enhance the quality of audit materially. Those who seek to argue that it is difficult to arrive at a single true and fair view of a company's performance and financial position should recognise the importance therefore of providing additional qualification and emphasis of matters to ensure that the user is in the best possible position to understand the significance of the accounting information presented. Equally the value of enhanced discursive reporting is considerable and ABI commends the developments in this area. It is important that audit opinions in respect of this are honest and open.

The caveats contained in audit opinions inevitably lead to a perception that the usefulness of the opinion is impaired. Investors would place greater value in honest and open opinions made in good faith without such caveats. Any qualifications about an audit opinion should relate to genuine uncertainties or challenges of judgment that relate to the audited entity and not to a reduction of scope of what the audit purports to be or to whom and for what purposes it is addressed.

The reliability of consolidated accounts is a matter that deserves some consideration. As businesses become more complex, as well as more international in scope, the importance of the financial results of subsidiary undertakings increases. Investors in the parent entity are just as concerned as to the reliability of subsidiary accounts consolidated into those of the parent but we are aware that auditing standards may differ significantly between jurisdictions, often in a way that investors are unaware of. It is essential that auditors of parent companies bring their critical faculties to bear in preparing consolidated accounts and do not approach it as little more than a mechanistic arithmetic task.

Factors Outside the Control of Auditors Affecting Audit Quality

Q13 Are there other external factors that have the potential to adversely affect audit quality?

- Q14 Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?**
- Q15 Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?**
- Q16 Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?**
- Q17 Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?**

The role of Audit Committees within the overall governance framework around financial reporting and internal controls has rightly been growing in significance in recent years. It is important that these should be effective in ensuring the avoidance and management of conflicts of interest and also that they can be an effective interface with the auditor. It is not acceptable for auditors to view company management as the primary manifestation of the audit client to which they owe their duty. It is vital that the audit committee in fact as well as in theory acts as the appropriate interface on behalf of the company and that the conduct of the auditor is consistent with this principle.

It has been mooted that the profile of audit committees should be further enhanced through a requirement for shareholders to vote on the adoption of a report from that committee, mirroring that which takes place on the remuneration report. This is a development which institutional investors do not call for. Rather, the focus should be on considering what enhancements can usefully be made in reporting by audit committees and in dialogue with investors that will, in turn, enable informed decisions by shareholders on resolutions about re-election of auditors.

Pressures caused by accelerating the reporting regime should not be permitted to impair audit quality. We are aware of concerns over the 'right first time objective' including the understandable and justified desire to avoid revisions to data promulgated in preliminary announcements of the company's results. It is understandable that prevalence of revisions could be taken as an indicator of problems with efficiency of the process. However, audit firms with confidence in their own professional standing should not feel inhibited, where relevant, from requiring appropriate revisions or further disclosures in audited accounts where, exceptionally, matters come to light at a late stage in the process of signing off the accounts.

Institutional shareholders consider that exposure to liability continues to be a very important stimulus to quality of audit work undertaken by firms. It is not evident to us that the equation has changed greatly in recent years. We support in principle the move towards proportionate liability as a basis, subject to shareholder approval, for avoiding unreasonable exposure by auditors for the failures of others. However, any cap on audit liability that immunises auditors from the consequences of their actions and protects them from the obligation to make good the economic consequences of their

failures can be expected to have serious implications for the quality and credibility of the audit process. The disciplinary functions of the FRC and the individual professional institutes have an important role to play in underpinning professional standards but they are complementary to, and should in no way be considered substitutes for, economic sanctions based on making financial redress for the consequences of professional failure.

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