



The Hundred Group
of Finance Directors

JEC Grant
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
LONDON
WC2B 4HN

29 March 2007

Dear Sir/Madam

Discussion Paper – Promoting Audit Quality

I am pleased to submit the comments of The Hundred Group of Finance Directors on the above discussion paper. We appreciate the opportunity to contribute feedback to this important subject.

The Hundred Group of Finance Directors represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange.

Our overall comments are set out below. A more detailed response is dealt with in the Appendix.

Audit quality and the perception of audit quality is one of the key drivers for the efficiency of the capital markets and the competitiveness of the UK

We strongly support the FRC's purpose of issuing the discussion paper in order to understand the views of the constituencies it serves and the need for audit opinions to give a robust and objective opinion on the financial statements.

We believe that the audit profession perhaps together with the help of other market constituents (including the FRC) need to more clearly define what "audit quality" should mean and provide the qualitative and quantitative measures that could be used to assess the "audit quality" definition.

We do have concerns that the number of audit quality related initiatives may perversely serve to undermine the perception of audit quality with a detrimental impact on the efficiency of the capital markets. We support the FRC in continuing to clearly articulate the purpose of the consultation at each stage of the process.

Financial reporting complexity and regulatory pressure is potentially detrimental to audit quality

The growth in complexity of reporting is leading to a greater reliance by audit firms on their technical departments that apply "rules" to a set of facts without necessarily having a deep knowledge of the circumstances or business context. This is an unhealthy development.

The profession is increasingly moving towards a more combative relationship with companies which discourages co-operation which ultimately could have an indirect impact on the quality of the audit. Part of this pressure appears to be regulatory driven.

We have a real concern that by narrowing the scope of work the major accounting firms can do (for instance, limiting non-audit services), the profession will be a less attractive place to be and fail to attract the talent that is needed.

The threat of audits firms being broken up due to monopolistic concerns, the ongoing consultations over litigation reform (if any at all), and the increasing reluctance of companies to fund audit costs that arise through regulatory creep (and have limiting value) are all uncertainties which reduce the attractiveness of audit as a profession.

The Hundred Group supports market driven change rather than regulatory intervention

We would agree that "audit quality" is a subjective matter and not easily measurable. We believe that where audit quality is deficient, companies do react by looking to alternate providers who are assessed on measures which are normally to some extent specific to the market participant concerned.

We would reserve support for any further regulatory intervention until the results of the associated Regulatory Impact Assessment were known.

The Hundred Group supports principles not rule-based standards

A common complaint in recent years we receive from auditors is the degree of prescriptiveness of auditing standards. We have several concerns:

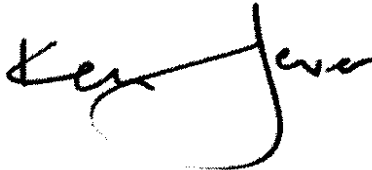
- Each time new auditing standards are issued, there seems to be a compelling argument proposed (although not always accepted) that the extra provisions will increase the auditor workload with a consequential increase in audit fee. The tangible benefit of the change in auditing standards on the audit process is not immediately clear to the company. It is of great concern that we have been informed that there are currently twenty six auditing standard exposure drafts;
- The Hundred Group support principle based accounting standards and accordingly, believes this should also apply to auditing standards. There is a risk that any rule based part of the regulatory regime undermines the efficiency of the markets;
- We believe a move towards prescriptive standards will dilute the quality of the audit profession (if a box-ticking mentality ensues) and could increase

company management exposure if the degree of rigour applied to the audit of the underlying business is lessened by a compliance rather than business issue focus;

- It would appear that recently with the advent of IFRS for listed companies that more focus is being placed by auditors on financial reporting as that is where the perceived audit risk lies which may if the rate of regulatory and standard setting is left unchecked be to the detriment of the audit of the underlying numbers on an ongoing basis;
- We perceive in practice much of the audit work can be superficial in nature if following rigid procedures and is frequently performed by inexperienced trainees. One of the difficulties facing the audit profession is that it traditionally places considerable reliance on the foundations of the pyramid (ie the trainees). This could be regarded as flawed as failure to identify problems in the detail may not be picked up later in the chain.

Please feel free to contact me if you wish to discuss our comments.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ken Lever'. The signature is fluid and cursive, with a large loop at the end of the last name.

Ken Lever
Chairman, Financial Reporting Committee
The Hundred Group

Appendix

The culture within an audit firm

Q 1 Are there other important indicators of an audit firm's culture that are not referred to above?

We believe the audit firm's implementation of how an audit is managed is fundamental. This extends not only to the audit approach undertaken but also the degree to which compliance rather than judgment is the benchmark for internal quality review processes.

We perceive that in practice much of the audit work performed can be superficial in nature if following rigid procedures and is frequently performed by inexperienced trainees. One of the difficulties facing the audit profession is that it traditionally places considerable reliance on the foundations of the pyramid (ie the trainees). This could be regarded as flawed as failure to identify problems in the detail may not be picked up later in the chain

We are aware anecdotally that the question of whether or not the right audit opinion has been reached is becoming somewhat diluted by the focus on compliance. If correct, we would regard this as a fundamental flaw of the regulatory system in the protection of investors (and company management) and could conceivably see why the audit approach may become more compliance and less judgment focussed.

Q 2 Are there pressures that could compromise the culture of audit firms that have not been identified above?

The audit profession appears to be somewhat under siege from regulators and investors which not only diminishes the efficiency of the capital markets by unnecessarily increasing premiums for service but reduces the attractiveness of the profession and hence, in the longer term will reduce quality.

The spread of frivolous litigation claims and the failure of the AIDB in the *Mayflower* case to provide a prima facie case are all unhelpful to promoting confidence in the market place and in the audit firms themselves. The threat of audits firms being broken up due to monopolistic concerns, the ongoing consultations over litigation reform (if any at all), and the increasing reluctance of companies to fund audit costs that arise through regulatory creep (and have limiting value) are all uncertainties which reduce the attractiveness of audit as a profession.

The culture of audit professionals operating with US registrants can at times be akin to fear which is not healthy. One feels that the UK audit firms are being far more reticent in their judgments and far more prone to seek out safe answers. Whilst some may consider this to be a good thing, we would note that following rules rigidly without thought is hardly conducive to audit quality or quality of financial reporting.

Q 3 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 regulator has a prominent role as ever in ensuring that those it regulates are treated fairly and where action is required to remedy any shortcomings of whatever nature, it is just and proportionate.

We strongly support active regulators to inspire confidence in the market provided they act consistently on a principles basis and work in conjunction with those they regulate in a constructive manner.

The skills and personal qualities of audit partners and staff

Q 4 Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?

We would agree.

Q 5 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?

None identified.

Q 6 Should there be a fundamental review of the qualification and training requirements for auditors?

We are not in a position to know whether the qualification and training requirement for auditors requires such a major step. We would note however the lead time between qualification of an auditor and his/her ability to influence the audit quality aspects of his/her firm would suggest this is an entirely separate debate which may be worth having but not one which will influence audit quality in the foreseeable future.

We do have concerns that any “dumbing down” of the training requirements would create a less able workforce not only for auditors but for UK plc as a whole.

The effectiveness of the audit process

Q 7 Are there other factors that determine whether an audit process is effective?

There is an implied assumption in the discussion paper that an audit methodology that complies with auditing standards without inhibiting exercise of judgment is not mutually exclusive. The assumption also suggests compliance is the mark of a good audit.

We would have thought that a review of the effectiveness of auditing standards may be a more sensible starting point to see whether they do indeed promote good audits or mere compliance. We are informed that the IAASB is issuing twenty six auditing exposure drafts this year to be effective for 2009 year ends – we find this to be a considerable number and are concerned that this represents either regulatory creep on an unprecedented scale or shows the current auditing standards are somehow flawed (albeit without any real evidence to suggest this is the case).

We have concerns that a number of international bodies that have tremendous influence on financial reporting and the capital markets are not subject to the same degree of governance that we would commonly expect in the UK which may not be in the best interests of serving the needs of the capital markets.

One assumes that there ought to be some form of Regulatory Impact Assessment for each and every one of these auditing standards to determine the cost benefit equation.

Q 8 Are there threats to the effectiveness of the audit process that have not been identified before?

We concur with the notion of “client capture” as a risk to the effectiveness of the audit process. Auditor or even audit firm rotation is seen as a “solution” to such risks but we would note that whilst this undoubtedly helps, one must also weigh this in relation to an understanding of the underlying business.

Continual rotation between audit professionals and/or audit firms may reduce the risk of client capture but increases the risk of a failure on the part of the firms and the audit individuals to fully understand the business; this is a greater risk with multi-national companies and for certain sectors.

The growth in complexity of reporting is leading to a greater reliance by audit firms on their technical departments that apply “rules” to a set of facts without necessarily having a deep knowledge of the circumstances or business context. This is an unhealthy development. We have noted the greater emphasis that seems to be placed by auditors on financial reporting risk as opposed to audit risk as that is where the perceived risk lies – whilst we welcome auditors helping companies getting the financial reporting correct, there is a concern whether this is at the expense of the underlying audit work.

Q 9 Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?

The degree of overseas regulatory creep is pervasive. The risk of duplicating regulation oversight is increasing and has the potential effect of diverting resources from the job at hand. We cannot comment on the audit process but from the experience of dual listed companies in the UK, considerable effort is taken in responding to different regulators often on the same or similar issues and not always with the same answer.

We would support a more unified regulatory regime which allowed national regulators to perform the primary role of regulation and welcome the recent announcement between the PCAOB and EC which suggests they may begin to rely on each others regulatory system.

The reliability and usefulness of audit reporting

Q 10 Are there factors that determine whether audit opinions command confidence?

The underlying reputation of an audit firm is helpful in inspiring confidence.

Q 11 Are there other reasons why users may not have confidence in the audit opinion?

A recent ICGN survey suggested a significant proportion of users were falsely assuming that the audit opinion covered more than it actually does. There is an education exercise that could be undertaken to clarify to users what an audit does and does not do to reduce the size of this expectation gap. Any misunderstanding is hardly likely to help confidence in the markets.

The degree of visibility of what constitutes “audit quality” is an important factor. We believe it is incumbent on the audit profession together with other market participants (including the FRC) to more clearly define what “audit quality” should

mean and provide the qualitative and quantitative measures that could be used to assess the "audit quality" definition.

If "audit quality" is not defined, it is difficult for company Audit Committee's to articulate to their users how they are comfortable with the work undertaken by the auditors and in turn, reduces the comfort of any audit opinion given.

Q 12 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?

We support measures to make the current audit report more readable and useful. We thought the ICAEW Audit Quality Forum working group's review of auditor reporting was comprehensive. Our response to the Audit Quality Forum is relevant to this question and is attached to this letter.

Factors outside the control of auditors affecting audit quality

Q 13 Are there other external factors that have the potential to adversely affect audit quality?

We would agree with the four main drivers as being highly relevant to audit quality. We believe that there are other drivers which potentially are a subset of these drivers but nonetheless warrant specific reference:

- The failure to provide a definition of "audit quality"
- The number of audit professionals relative to the workload
- The professionalisation of the audit professionals
- The regulation of audit judgement
- The degree of regulatory change and volume of regulation

The failure to provide a definition of "audit quality"

The degree of subjectivity of what constitutes "audit quality" is a barrier to:

- enhancing the due process of appointment auditors with due care and most importantly, the process being seen to have been undertaken with due care;
- articulating how Audit Committees are happy with audit services provided; and
- improving the communication with users of how auditors are measured.

Number of audit professionals relative to the workload

Whilst quantity in of itself is not going to drive audit quality, a lack of trained auditors could seriously undermine quality.

We are conscious in our recruitment of financial professionals that the accountancy firms are a good training ground. If the recent experience of companies trying to recruit trained accountancy professionals (whether to implement IFRS or to tackle the implementation of SOX 404 for example) is a sign, then there is a lack of abundant talent. One can suggest that this may be a temporary blip in requirements for trained financial accountants (typically from an audit background) but the extensive (and we would argue, more difficult) demands of IFRS are likely to continue to be a drain for the foreseeable future.

Although there is no short term fix, it is a major concern for UK plc of where the next generation of audit and accountancy professionals are going to come from if the current demand is maintained. Hence, we would caution against introducing measures without adequate consideration of any potentially adverse impacts on the supply of accountants/auditors. For example, we would caution against measures such as introducing more prescriptive auditing standards and compliance rules for auditors beyond the current regime.

Professionalisation of the audit professionals

We support the current professionalisation of the audit and accountancy profession within the UK and the ability of both graduates and non-graduates to become members subject to the various institute requirements.

We believe that audit is a valuable skill and would urge the institutes to ensure it remains one of the core skills developed and taught both through lecture and on the job training.

The regulation of audit judgment

We support the need for regulation of audit judgment but in a way which is helpful to the capital markets. Any onerous regulatory regime will reduce the attractiveness of the profession and possibly regulatory regime and may lead to a decrease in quality if the number of individuals to undertake these roles is reduced.

In a recent survey the Hundred Group undertook designed to capture SEC registrants' experiences in 2006 with respect to SEC comment letters following the implementation of IFRS, trends emerged that the tone of the SEC comment letters received was unhelpful and unduly regulatory in nature. One respondent articulated a general concern that: *"While the questions and comments are legitimately raised, we are concerned that the SEC's approach may have the effect of creating an "SEC-IFRS" applicable just to foreign private issuers that diverges from the general application of IFRS. This potentially has wide ranging implications and one that should be debated openly by those being regulated and by other regulators such as CESR and the FRRP who also have an interest in the interpretation and application of IFRS by European and UK listed companies in particular."*

We believe that a similar concern may arise with the PCAOB overseeing UK audit firms. Whilst for the avoidance of doubt, we regard this interaction as appropriate in relation to listing within a foreign regime, the US typically has a far more intrusive and combative approach which can decrease the attractiveness of being listed there as a company or being a professional dealing with foreign registrants. Hence, we would regard the overall regulatory regime in the UK including the access of foreign regulators as being critically important to the capital markets in upholding good audit judgment in a constructive manner.

The degree of regulatory change and volume of regulation

There appears to be a large amount of change at present within the auditing profession, some of which is very welcome.

We are informed there are twenty six exposure drafts for (revised and new) auditing standards issued by the IAASB that are likely to have an effective date for periods commencing on or after 15 December 2008 and that the number of mandatory requirements on auditors may substantially increase. Some of these

changes may be beneficial but we have concerns that this reflects regulatory overkill and has all the hallmarks of a compliance rules based system being introduced into the UK through the backdoor.

Audit quality we believe should centre on professional judgment using base principles of auditing which should allow audit professionals to exercise judgment for the genuine risks within the business.

We have a real concern that by narrowing the scope of work the major accounting firms can do (for instance, limiting non-audit services), the profession will be a less attractive place to be and fail to attract the talent that is needed.

Q 14 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?

We believe Audit Committees are discharging their responsibilities in relation to audit adequately. It is common for Audit Committees to review the audit planning, results and conclusions and discuss with the auditors their views both with and without management.

The auditors understanding of the business and way in which the audit is carried out and the significant findings thereon give an Audit Committee considerable scope to challenge the effectiveness of the way in which the audit is carried out. Together with the fact that Audit Committee members typically sit on more than one such committee or are in executive roles dealing with auditors, allows them to compare and contrast between audit approaches.

As noted above, we do believe it is incumbent on the audit profession to try to enhance the understanding of all constituents by what is "audit quality".

Q 15 Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?

Some form of guidance may help as part of what constitutes "audit quality" so that some form of uniformity of approach to the questions one should ask when assessing new auditors or current auditor effectiveness is established. Given the subjectivity of audit effectiveness, one would hope that any such guidance is illustrative in nature.

Q 16 Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?

In principle this seems sensible. However, given the degree of boilerplate reporting that currently exists within annual reports (in of itself a response to legal protection for the directors), we would suggest that this may not be a significant help to inspiring confidence.

We would also take the opportunity to note that most corporates now can provide such information on their website which may be a more useful and timely forum in which investors can assess the Audit Committee's role in assessing audit effectiveness.

Q 17 Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?

None noted.



The Hundred Group
of Finance Directors

Philip Broadley
Chairman: The Hundred Group
c/o Prudential plc
Laurence Pountney Hill
London
EC4R 0HH

Direct dial : 020-7548-3905
Direct fax : 020-7548-3303
E-mail : philip.broadley@100groupfd.co.uk

Sumita Shah
The Institute of Chartered Accountants in England & Wales
Gloucester House
399 Silbury Boulevard
Central Milton Keynes
MK9 2HL

27 November 2006

Dear Sumita

Audit Quality Forum
Audit Quality: Fundamentals – Auditor Reporting consultation draft

I am pleased to submit the comments of The Hundred Group of Finance Directors on the above consultation draft. The Hundred Group of Finance Directors represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange.

We support measures to make the current audit report more readable and useful. We further support improvements in governance and financial reporting and welcome the working group's comprehensive review of auditor reporting. We have highlighted our specific views and concerns below. We would note that in our routine dealings with shareholders audit reporting has not been raised as an area of current concern.

Purpose of the audit and audit report

The current audit report has developed through its many iterations over time. It has become cumbersome and some restructuring could be beneficial.

However, we would be concerned if a higher level of assurance was required for a positive statement (in relation to adequate accounting records and matters to be brought to the attention of shareholders) to be made by the auditors in the audit report. One would hope that there should be no need to fundamentally change auditing standards. One could conceive of a situation where additional auditing standards and regulatory creep could be

introduced at increased cost to companies which may detract from any benefit to shareholders of more clear disclosure.

Of the recommendations the working group propose, we would have no objections (subject to the caveat above) to the following changes to the audit report:

- An opinion paragraph adopting early the wording and structure of clause 509(3) of the Companies Bill in its three distinctive parts;
- A positive statement that adequate accounting records have been kept;
- A positive statement that there are no matters that auditors wish to draw attention to by way of emphasis under section 235(2A)(b) or clause 509 (4)(b) of the Companies Bill;
- Moving the opinion paragraph to the front of the audit report.

Information flows

We concur with the views of the working group on the corporate governance framework and believe the UK has one of the most advanced and successful corporate governance models in the world. Any change to that model (especially with regards the interaction between shareholders, companies, non executive directors and auditors) would need to be undertaken in a measured way not to adversely upset the balance that currently exists.

A widening of the contact between auditors and shareholders would need to address the following points:

- It would require, as the working group acknowledges, a waiver of the duty of confidentiality of the auditors which may be unworkable in practice as it would potentially undermine the current audit relationship that exists;
- A widening of contact would need to show that it gives rise to a demonstrably better answer. The Combined Code already has a series of measures to allow shareholders to question the NEDs, especially the senior independent director. This allows an independent and more up to date view of a company's issues, risks and prospects and reflects the NEDs primary responsibility;
- The practical, governance and most importantly, legal status of an increase in communications between auditors and shareholders is untested. The benefits of this approach would need to be articulated and tested given the potential costs involved of such a change.

Shareholder expectations

We can understand why shareholders take the view that audit reports are boilerplate and overly standardised. We support making the current audit report more shareholder friendly and reasonable. However, this does not necessarily mean one should strive for less standardisation and more differentiation as comparability and understandability are often cited as important characteristics for shareholders.

We believe for the efficiency of the markets, some standardisation in the audit opinion is a necessity and should therefore be maintained. Additional information in the audit report may allow differentiation between companies but very careful consideration and research is required before this should be seriously considered.

Additional company specific information provided by the auditors in their audit report may be helpful and relevant to shareholders. Such information would probably need to have as a minimum the following characteristics:

- Factually accuracy - the information would need to be factual as this would allow agreement between the auditors and company and minimise the need for extensive legal debate on drafting and scope.
- Objectivity -the information may not be able to refer to judgmental positions taken by the auditors on specific issues. The audit opinion is based on the fair presentation of the accounts as a whole and to widen the auditors remit may give rise to unintended

consequences (for example, reduced materiality levels and increase in the amount of work involved and cost to the company).

- Understandability - the information would need to be articulated in a simple way. Some accounting concepts do not lend themselves to succinct explanations and the audit report if too voluminous may lack clarity.
- Legal robustness - some information could be commercially sensitive or detrimental to the company. More difficult audit issues can concern such matters and therefore the degree of disclosure (if any) is likely to limit the usefulness of such information. A partial disclosure of information may not give rise to a better answer for shareholders if it only provides part of the overall picture.
- Net beneficial outcome - any changes need to prove that they give rise to a demonstrably better answer than the alternatives. For example, the corporate governance system allows the concerns of shareholders to be addressed in a way which the auditors are unlikely to be able to fulfil through their audit report.

Any company specific reporting which shares these characteristics may prove to be standardised. Given the nature of the capital markets, director and auditor risk, such disclosures would need to be legally robust and this may further lead to generic boilerplate disclosures which may be of limited use to shareholders.

French audit report model

We do not oppose the French audit report model in principle as it appears to meet the characteristics above. We do however feel that for the most part the information provided is already likely to be found in the financial accounts and/or forms the basis of auditing standards and as such adds no new information. For instance, a summary of key accounting estimates and judgements is a requirement of IFRS (IAS 1) which companies will already be disclosing. We do not feel that repeating this information as outlined in Appendix F together with outlining the auditing requirements is particularly beneficial although we acknowledge that shareholders may feel they get some incremental implied comfort.

Where complex multinationals are concerned with multiple issues, there is a danger that this approach may give rise to many pages of additional information and therefore not provide the clarity sought.

Audit Committee enhanced reporting

A number of the observations above would equally apply to the Audit Committee report presenting a greater overview of the audit reporting process. However, this may be a route which can be achieved more easily and would possibly reduce the time for consultations between companies and their auditors on the content.

In conclusion, we are in favour of adapting the audit report in its current state to help shareholders and subject to research and certain safeguards would be willing to support further changes if there is a demonstrable benefit for the capital markets.

Please feel free to contact me if you wish to discuss our comments.

Yours sincerely

Philip Broadley

