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THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



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30 March 2007

Dear Jon

DISCUSSION PAPER: PROMOTING AUDIT QUALITY

Overall Comments

The ICAS Audit and Assurance Committee and its Business Law Committee welcome this discussion paper and its stated objective. We strongly support the FRC's view that any fundamental review of the financial reporting regime should take place only after recent changes have been fully assimilated by all concerned i.e. the introduction of ISAs; introduction of APB Ethical standards for auditors; introduction of IFRS for listed groups; the Companies Act 2006 et al.

The report appears to focus largely on the audits of listed entities. Although the drivers identified are equally relevant in the unlisted company environment the paper should have been more explicit that it was written with listed entities primarily in mind. We understand that audits of smaller entities will be the subject of a separate consultation being carried out by the APB.

We are generally supportive of the content of the paper although we do have the following comments.

Drivers of Audit Quality

As indicated above we agree with the drivers identified in the discussion paper. However, we also consider that the following are worthy of note.

Legal and Regulatory Framework

The report does not specifically highlight that the legal and regulatory framework in a particular jurisdiction is a primary driver of audit quality. In the UK we have a very well developed legal and regulatory framework and this underpins the audit process which we believe has a positive impact on audit quality. In contrast, the quality of audit is threatened in jurisdictions which do not have adequate legal and regulatory systems in place. Therefore, we believe that the report is rather narrow in focus in relation to identifying the main drivers of audit quality and that it should take account of wider environmental factors.

Culture/Society

We note that the FRC seeks comments from respondents from other jurisdictions. We believe that the culture and accepted norms of a society impact upon audit quality. In certain jurisdictions, corruption/fraud is prevalent and this can be a major threat to audit quality. As many listed entities now have operations in different parts of the globe the need to find global solutions to audit quality is readily apparent. Many UK listed entities in fact derive large percentages of their profits from overseas operations and this will increasingly be the case for UK groups. Therefore, these environmental factors in different jurisdictions may affect the overall quality of UK group audits.

Audit Committees

The importance of the audit committee is noted in the paper but we believe that this body demands greater focus and that its review of the objectivity and effectiveness of the audit process is one of the key drivers of audit quality. Indeed anecdotal evidence suggests that in recent years the effectiveness of audit committees has considerably improved with auditors being stringently challenged about their performance. The FRC should prepare guidance for audit committees and we have enclosed a copy of our guidance “Appraising Your Auditors” which is designed for use by audit committees and has been warmly received by business– it should be noted that this was last updated in 2003 but is due to be revised soon.

Threats to Audit Quality

Standards becoming more rules based

As identified in the discussion paper, concerns are raised by both auditors and audit clients that current requirements result in too much effort being directed towards compliance procedures and ticking boxes. This emphasis on methodology detracts from the exercise of judgement and the ability to assess the overall position expressed in the financial statements. Inevitably if judgement is not used then there is greater potential for untoward behaviour to go undetected. The perceived quality of an audit may be improved if auditing standards were flexible enough to meet the size and needs of different companies and therefore standards should be based on principles rather than rules.

Potential Weakening of ‘True and Fair View’

We believe that the supremacy of the true and fair view has been challenged in recent years and are concerned that it may be seen by some as mere compliance with detailed accounting requirements. Such an approach will have a negative impact on the quality of financial reporting and auditing and must be strongly resisted. A true and fair view should be the over-arching consideration of preparers and auditors of financial statements, going beyond compliance with accounting standards. We therefore welcome all the initiatives that have been undertaken to defend the “true and fair view” as the cornerstone of UK financial reporting.

Knowledge of Business vs. Independence (Rotation)

Knowledge of the business is key to an auditor being able to undertake an effective audit. However, it is also recognised that long-term association with a client may have a negative effect on the perceived independence of the auditor and hence the need for rotation of audit partners. Concerns have been expressed in recent months that the existing five year rotation requirements in the listed company sector in the UK may inadvertently have a negative impact on audit quality particularly in specialised sectors. Key partners are replaced without always having someone of sufficient experience of the client/industry to replace them. We believe that the risk of actual lack of independence through long association is generally overstated in today's litigious and reputation-led audit environment. Independence is an attitude of mind, rather than something which is corroded through the passage of time. It would be helpful if research was undertaken to investigate the impact of partner rotation on audit quality. We also note that the International Ethics Standards Board for Accountants intends to retain a seven year rotation rule for partner rotation and recommend that the APB consider doing likewise in its forthcoming review of its ethical standards for auditors.

Provision of Audit Related Services

We are receiving more comments from our members in business that their auditors cannot assist them with respect to financial reporting queries— all the auditor will do is to approve or disapprove of a particular accounting treatment. This is considered to be unhelpful and taints the perception of a quality service. There is also a lack of understanding in the business community as to what services the auditor can actually provide, as well as practical problems in the application of the requirements of APB Ethical Standard No. 5.

Impact of Technology

The discussion paper notes that information technology has affected the speed and quantity of transaction processing in the business world. It has also affected the way in which auditors, and others, work with much of their focus on the tools of the job, whether this is controls testing of the client's accounting system or using email to elicit information. We agree with the concerns stated in the paper that members of the audit team being stuck in the audit room behind the PC may be detrimental to audit quality because it prevents them from being out and about looking at how a business operates and from conducting face to face discussions with key client personnel.

Level of Audit Documentation

The above point is also directly related to the level of documentation required by the ISAs which in itself is a potential threat to audit quality. Too much valuable audit time is being spent on matters of a documentary nature.

Recommendations

We recommend that the FRC should consider the following:

1. Undertaking research into the impact on audit quality of the partner rotation requirements in APB Ethical Standard 3.
2. Promoting the use of principles based standards both domestically and internationally.
3. Through its membership of the International Forum of Independent Audit Regulators, the FRC should promote the adoption by other jurisdictions of appropriate legal and regulatory frameworks for financial reporting.

4. Developing guidance for audit committees. We enclose a copy of our guidance “Appraising Your Auditors” which is designed for use by audit committees and has been warmly received – it should be noted that this was last updated in 2003 but is due to be revised in early course.

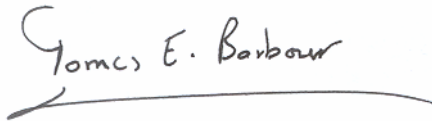
Responses to the FRC’s Specific Questions

These are detailed overleaf in the Appendix.

Please do not hesitate to contact me should you wish further clarification on any of the above points.

Kind regards,

Yours sincerely

A handwritten signature in black ink that reads "James E. Barbour". The signature is written in a cursive style and is underlined with a single horizontal stroke.

JAMES E BARBOUR
Director, Accounting & Auditing

APPENDIX**Responses to Specific Questions**

Q1. *Are there other important indicators of an audit firm's culture that are not referred to above?*

We believe that the principal indicators have been identified within the paper.

Q2. *Are there pressures that could compromise the culture of audit firms that have not been identified above?*

One potential threat is the growing prevalence of more prescriptive standards in financial reporting, auditing and ethics which may drive firms towards an audit culture of tick-box compliance with standards which we envisage would have a negative impact on audit quality. This may also make it more difficult to attract high calibre new entrants into the profession. The removal of professional judgment by prescriptive standards is undoubtedly a threat to the culture of an audit firm.

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?*

We are not currently aware of any such steps that should be taken.

Q4. *Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?*

Yes.

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?*

We believe that further mention could be made of the importance of training in ethical issues.

Q6. *Should there be a fundamental review of the qualification and training requirements for auditors?*

We do not believe this to be necessary at this time.

Q7. *Are there other factors that determine whether an audit process is effective?*

We believe that the main factors have been identified.

Q8. *Are there threats to the effectiveness of the audit process that have not been identified above?*

We have highlighted some issues in our general comments above – in particular our belief that the current partner rotation requirements may be inadvertently having an adverse effect on audit quality.

Q9. *Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?*

As mentioned earlier, we believe that the FRC should promote the benefits of principles based standards on the global stage to guard against the introduction of overly prescriptive accounting, auditing and ethical standards into the UK.

Q10. *Are there other factors that determine whether audit opinions command confidence?*

The reputation of the audit firm is seen by various stakeholders as a key factor.

Q11. *Are there other reasons why users may not have confidence in the audit opinion?*

No.

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?*

We do not believe at this time it is necessary to propose any further changes. We do not believe that there is any merit in requiring disclosure in the audit report of the basis of auditors' conclusions.

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

We have referred to such issues in our general comments.

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?*

Anecdotal evidence suggests that in recent years the effectiveness of audit committees has considerably improved. This is obviously due to a number of factors. We currently do not believe that any further steps are necessary at this point in time.

Q15. *Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?*

ICAS has issued guidance that has been welcomed by the business community and we have included a copy with this submission.

Q16. *Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?*

Whilst we welcome this suggestion, our concern would be that this would merely add to the existing length of the annual report which many stakeholders already believe is too long.

Q17. *Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?*

ICAS is supportive of the report 'Risk, Responsibility and Regulation – whose risk is it anyway' issued in 2006 by the Better Regulation Commission, which questions whether all risks can be addressed by regulators. We believe that the FRC currently takes adequate steps to address risks associated with external factors that may affect the audit process.