



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

March 28, 2007

Mr JEC Grant
Financial Reporting Council
5th Floor Aldwych House
71-91 Aldwych
London WC2B 4HN
United Kingdom

By email: j.grant@frc-apb.org.uk

Dear Jon

FRC DISCUSSION PAPER, “PROMOTING AUDIT QUALITY”

As Chairman of the International Auditing and Assurance Standards Board (IAASB) I am pleased to have the opportunity to comment on the UK Financial Reporting Council’s November 2006 Discussion Paper “Promoting Audit Quality” (the “Paper”), and to thank again Richard Fleck and Paul George for presenting the Paper to the IAASB in December. The IAASB has not had the time on its agenda to discuss the Paper in depth, but I have had the benefit of views from the Steering Committee. Nevertheless, this letter is more by way of a personal reaction, informed by the international context in which IAASB operates.

The IAASB shares your interest in the subject of audit quality. The quality of an audit depends not only on the auditing standards with which the auditor has complied but also on many other factors. As such, I am pleased that the FRC has expanded the scope of the debate beyond auditing standards to include a broader consideration of other factors that are central to achieving a high quality audit. The publication of the Paper is also timely as it will provide relevant input into the IAASB’s current consultation on its future strategy and work program.

Whilst the IAASB has an interest in the responses to all the matters discussed in the Paper, my comments below focus on matters relating to auditing standards only. As a matter of general comment, however, I think that the Paper provides a comprehensive and appropriate analysis of the issues covered. My main concern, as mentioned below, is whether sufficient importance is being given to the potential effect that recent regulatory changes may have in the longer term.

DISCLOSING THE AUDITOR’S BASES OF CONCLUSIONS IN THE AUDITOR’S REPORT

In paragraph 1.19, the Paper suggests, in its overview of the current environment, that there is an ‘increasing climate of distrust’ between investors and auditors which is leading commentators to call for greater transparency in the audit and financial reporting process. In paragraphs 6.9–6.13, under the section dealing with the reliability and usefulness of audit reporting, it notes the

existence of a debate within the UK Audit Quality Forum as to whether audit reports should be more informative about the key audit issues and how they were resolved. The Paper further notes some institutional investors' views that there may be merit in requiring disclosure in the auditor's report of the basis of the auditor's conclusions similar to that required by French legislation (the "justification"), and suggests the need for consultation involving all affected constituencies.

These concerns are not new. There is more distrust than formerly, but I take the view that it may have peaked, rather than being on the increase, and that the actions of regulators, legislators and auditors themselves are helping to restore trust. There is a need for the profession to communicate with the public about the auditor's work and the meaning of the audit opinion in the resulting auditor's report. In this regard, the IAASB has been striving to explain the nature of its work and its objectives through such actions as involving a sizable consultative advisory group (including regulatory and investor organizations) in its standard-setting and related processes, investing time and effort in communicating with its various stakeholders, and making its processes transparent.

Whilst there may be a perceived merit in requiring further disclosure in the auditor's report of the basis of the auditor's conclusions, requiring the auditor to justify his or her conclusions may not necessarily lead to a better understanding of the audit opinion, nor allow the users to evaluate the quality of the audit. Indeed, because disclosure may not be made consistently across audit firms and audit engagements, there could be a risk of its leading to an unconstructive outcome. For example, it could cast doubt on the audit opinion as users may not fully understand the effect of the auditor's explanation of the basis of the auditor's conclusions, or users could seek to challenge such rationale and therefore the auditor's judgment. Some analysis of the experience in France, to which the Paper refers, would be informative.

The IAASB encourages consultation amongst all affected constituencies as to how to improve the auditor's communication to the users. Important questions would be whether in fact the information sought is about the financial statements (in which case, the proper disclosing party would be the entity itself) or the audit (disclosure being the auditor's responsibility); and secondly, what information would be both beneficial and actually used. The provision of information has a cost, both in terms of its delivery and its use; information is also rarely regarded as enough (see, for example, paragraph 3.6 of your Paper in connection with transparency disclosures). In so far as audit reporting standards are concerned, the IAASB does not believe that changes should be made without clear user and regulatory demand, and until sufficient consensus emerges amongst all parties as to the form of such changes.

In this regard, the IAASB would like to highlight that, in conjunction with the American Institute of Certified Public Accountants and the American Accounting Association, it is commissioning a research project into auditors' report communications. The IAASB hopes that the results of this research project will inform any future initiatives on audit reporting.

OVER-PRESCRIPTIVE AUDITING STANDARDS

In paragraphs 5.19–5.24, under the subheading "Possible threats to an effective audit process," the Paper suggests that over-prescriptive auditing standards may encourage auditors to adhere strictly to the letter of the applicable standards, and detract from the proper application of professional judgment necessary in a thinking audit. It also suggests that pressure from regulators

internationally for standards which can be more easily enforced has been leading to greater emphasis on the procedural aspects of an audit.

I should like to emphasize that IAASB is committed to a principles-based approach to auditing standards that encourages the appropriate exercise of professional judgment. Nothing has occurred in the recent past that has fundamentally altered the IAASB's belief that this is the best approach. Some regulatory pressure does exist on the IAASB to make the standards more prescriptive, but it is not the case that all regulators take that approach. The IAASB tries to give a balanced response to all views that it receives in response to its consultative activities.

It is right, however, to note that all regulators are concerned to ensure that standards are enforceable. We share that concern, and again observe that there are differing views on what makes a standard enforceable. In this connection, I note that the Paper does not seem to give much emphasis to regulation and enforcement – for example, it is not listed as a key driver on page 16. Substantial regulatory change has taken place over the past 5 years, much of which has been concerned to make the regulation of auditors independent of the profession. This has included certain enforcement and disciplinary activities. There is scope for research to investigate the implications of these changes. For example, are standards written primarily to improve the quality and consistency with which auditors perform their work, and which have traditionally been enforced by fellow professionals (and ultimately the courts), equally appropriate in an environment where auditors are being judged by others outside the profession? It is too early to draw conclusions, but the longer term effect of the changed regulatory landscape may well be more significant than expected.

Insofar as its auditing standards are concerned, the IAASB would also like to highlight that those that have been recently revised have dealt with some of the more complex aspects of the audit. Their perceived complexity is not necessarily because they contain more procedural requirements but because the business environment and financial reporting frameworks themselves have increased in complexity (as the Paper itself acknowledges in paragraph 1.12). In addition, although there has been an increase in the number of requirements of proposed redrafted and recently issued IAASB standards, as a result of the IAASB's clarity project, the purpose has been to make the standards clearer and less ambiguous so as to facilitate more consistent application. The increase in the number of requirements has been well below the somewhat alarmist predictions of the most gloomy commentators, and in no way undermines our basic belief in principles-based standards.

Further, international discussions have suggested that professional judgment tends to be exercised differently by auditors from different environments and cultures. From its consultative processes, the IAASB has been given clear direction that it should seek to drive better performance by focusing more specifically on areas in which the auditor needs to exercise significant professional judgment, and emphasizing that such judgment be documented.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

Paragraph 6.6 of the Paper, under the section dealing with the reliability and usefulness of audit reporting, emphasizes that two-way communication between the auditor and the audit committee is likely to make a key contribution to a high quality outcome to the audit.

The IAASB shares this view. The IAASB recognizes that different governance models exist around the world, and the differences in governance processes amongst various jurisdictions became all the more clear when it set out to revise its auditing standard dealing with communication with those responsible for governance (ISA 260). In finalizing this standard, the IAASB specifically took into account these differences in seeking to strike a neutral stance under any governance model regarding the auditor's obligations vis-à-vis those parties responsible for governance. The IAASB therefore believes that the revised ISA 260, which is currently being redrafted under the clarity conventions, will go a long way towards addressing effective two-way communication between the auditor and those charged with governance, irrespective of the local regulatory and governance environment.

Please do not hesitate to contact me or Jim Sylph, IFAC's Executive Director, Professional Standards, (jimsylph@ifac.org) should you wish to discuss any of the comments.

Yours sincerely

A handwritten signature in blue ink that reads "John Kellas".

John Kellas
Chairman, IAASB
(johnkellas@ifac.org)